

# ECONOMIC PAPERS

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- COUNTRY STUDIES -



## **COUNTRY STUDIES\***

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## EXECUTIVE SUMMARY

Since the beginning of the eighties, the operation of the French economic policy has undergone a far-reaching conceptual change of approach. The economy has been increasingly exposed to the steering mechanism of the free market and previous regulatory concepts were abandoned. Ideas of "planification" were replaced by increasing use of the price mechanism. Credit policy changed from direct steering techniques to indirect methods via the interest rate in increasingly liberalized markets. Moreover, monetary policy with more and more credibility reflected the hard-currency option of the EMS. In this framework, the economy has achieved a greater ex-ante rationality in income distribution. State intervention has been increasingly reduced and competitiveness strengthened. Thus, the pre-conditions have been laid down for a successful expansion within the context of greater Community integration after 1992.

The new macroeconomic framework in France, which gives priority to nominal stability, has proved successful in particular as regards the achievement of monetary policy in keeping inflation under control. In view of uncertainties surrounding the German economy, the responsibility on French monetary policy in the EMS context is growing so that monetary policy should maintain its stability and medium-term oriented stance. Further interest rate reductions, which are quite likely to materialize, should reflect market forces, i.e. room for lowering short term rates should be exploited cautiously.

Fiscal policy is consistent with a stability-oriented policy mix as the public sector deficit is very small. However, the tax pressure is quite heavy and given that integration imposes limits on the taxation of mobile factors priority should be given to control expenditures, e.g. social security expenditures (and contributions) which are relatively large. Distortions in the tax structure (taxation of saving and high taxes for low and very high income levels) might be alleviated by broadening the tax base (direct taxes, immobile factors). Taxation of enterprises also appears to be somewhat high, involving potentially detrimental effects on the real rate of return on investment.

The disinflation process was largely facilitated by favourable labour market behaviour: the considerable nominal and real wage moderation due to both changes in policy and market behaviour achieved over the 1980s was the principal factor in the restoration of profit margins. For a number of reasons, it is of paramount importance that this trend continues.

Firstly, the increase in real interest rates during the 1980s requires an adjustment towards levels more consistent with the relative scarcity of capital in the functional income distribution in favour of capital. Secondly, in an international perspective, the real wage level in France should be consistent with a satisfactory level of profitability relative to other countries and thirdly, the high unemployment (in part due to strong growth in the labour force) requires a higher economic growth path. Therefore, real wages should temporarily grow below productivity growth. This will stimulate capital accumulation and contribute to an equilibrium real wage level which will allow to reduce existing unemployment in France.

Measures to reduce structural rigidities which remain in the French labour market should be announced and implemented. Greater vertical wage flexibility (SMIC), more flexible use of the capital stock and a reduction in the insider-outsider effect by effective measures to reintegrate unemployed workers into the labour market would all seem desirable.

The enterprise sector increasingly operates in a market and internationally-determined environment. The strong acceleration of foreign direct investment abroad indicates that French enterprises no longer give overriding priority to the domestic market. A strengthening of competitive forces may also reduce the competitiveness problems which have persisted in the French economy and make France more attractive to foreign investors too.

All in all, the study shows that France is increasingly reaping the benefits of the new policy framework introduced in the 1980s but that in order to reap them fully the present course has to be maintained. On the recent conjuncture, there is no alternative but to rely upon further supply-side improvements as the major means for improving the employment performance. With alternative responses, France would be affected by major setbacks for its economy arising from losses in credibility and the attractiveness as a place for investment in the single market: furthermore, the unavoidable and (significant) adjustment costs of the new policy would have been wasted.

Only supply side improvements would strengthen growth prospects and would also enhance the attractiveness of France as a site for investment in the Single Market, a factor which will become more and more important as economic and monetary integration proceeds.

## PART I

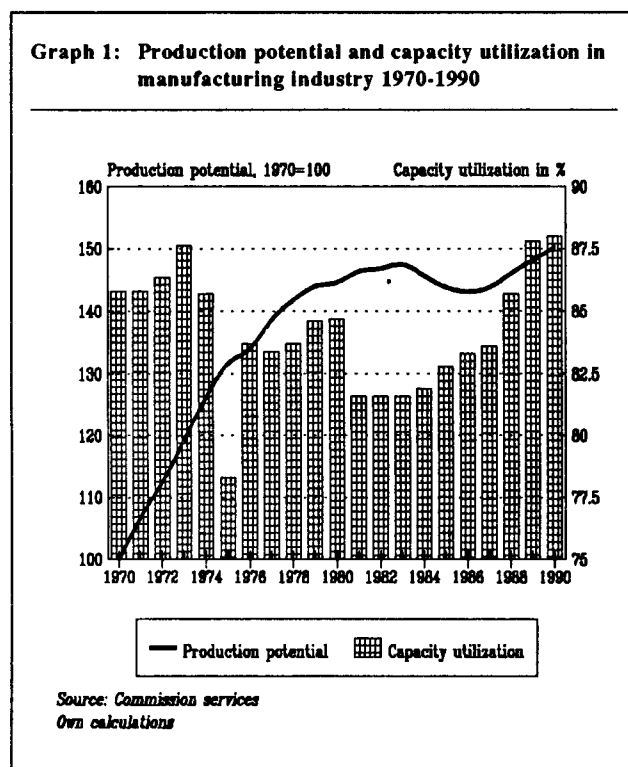
## INTERACTION BETWEEN MICRO AND MACRO-ECONOMIC PERFORMANCE

## 1. Macro-economic performances and policies

## 1.1 Economic growth in France: an assessment

After the very slow growth in the first half of the 1980s, GDP growth in France recovered in 1986, somewhat later than in the other European countries. Due to this acceleration of GDP growth, employment rose by around 1% per year from 1988, after having fallen in the first half of the 1980s.

Potential output in manufacturing has increased steadily at a rate of some 2.5% per year since 1986 (see Graph 1)<sup>1</sup>. This performance, however, has to be compared with very slow growth in the mid-1980s when potential output in manufacturing actually declined after several years of low investment. The level of the early 1980s was regained only in 1988. The main factors behind the better investment performance were improving profitability, terms of trade gains and the buoyancy of world trade.



Medium-term prospects for employment will crucially depend upon a continued strong investment performance and a corresponding growth of potential output. This is particularly true for the manufacturing sector. Indeed, weak growth performance during the mid-1980s significantly reduced the employment potential in manufacturing.

Despite improved investment, however, unemployment remains stubbornly high. The rate of unemployment, affected by significantly rising labour supply, increased steadily until 1987, peaking at more than 10% two years later than the Community average. Since then unemployment has declined, but at a slower pace than in most other Community countries. Being the principal macroeconomic imbalance of the French economy, the relatively high unemployment rate warrants a thorough examination.

More recently, the economic growth performance of France has deteriorated mainly due to a deceleration of growth in world trade. Although competitiveness has not been reduced significantly vis-à-vis ERM countries during the last two years, the recent acceleration in wages might affect growth in two respects: high wage settlements will not only affect competitiveness (exports) but through their impact on profit expectations they are likely to reduce investment and thus job creation. Weaker investment due also to lower demand expectations, is indeed the main domestic contributor to the recent deceleration of growth in France and to rising unemployment.

In 1989 and 1990, wages per head rose around 5%. This is not consistent with an improvement in profitability during a phase of economic slowdown. Indeed, crucial sectors of the French economy have already experienced a significant drop in profitability, whose more satisfactory level was an important factor behind investment growth: the falling trend in real unit labour costs, the best indicator of profitability, was interrupted last year. However at the beginning of 1991 the risk of wage inflation is less obvious.

The discipline in price-setting behaviour which originates from the more competitive internal and external environment has its counterpart in a greater response of profits to wage developments. Moreover, high wage settlements will also have important repercussions on the conduct of stability-oriented economic policies. This

<sup>1</sup> Potential output is here proxied by dividing value added in the manufacturing sector by the survey based figures on capacity utilization i.e.  $PO = VA.100/CU$ , where PO denotes potential output, VA value added in manufacturing industry and CU the survey based rate of capacity utilization.

would directly influence the credibility of monetary policy and reduce the room for manoeuvre for further market-based reductions of interest rates. Indeed, the impressive reduction of interest rate differentials against the DM has to be preserved, otherwise the necessarily rising interest rates could trigger an unwarranted restrictive influence on the present fragile cyclical situation.

The scope for using fiscal policy to effectively counteract a cyclical slowdown continues to be rather limited. The declared target of an ongoing reduction in the fiscal deficit would have to be abandoned in the event of discretionary demand management. A larger fiscal deficit - even if only due to the working of automatic stabilizers - could be interpreted by the market as a signal of a more accommodating fiscal policy and would in these conditions be self-defeating.

From a macroeconomic point of view, the possibility of the French economy achieving a higher growth trend depends upon whether it would impede other targets of economic policy. A lower level of unemployment can only be durably sustained if inflation remains low. Thus, a reduction in unemployment depends upon an appropriate degree of labour market flexibility.

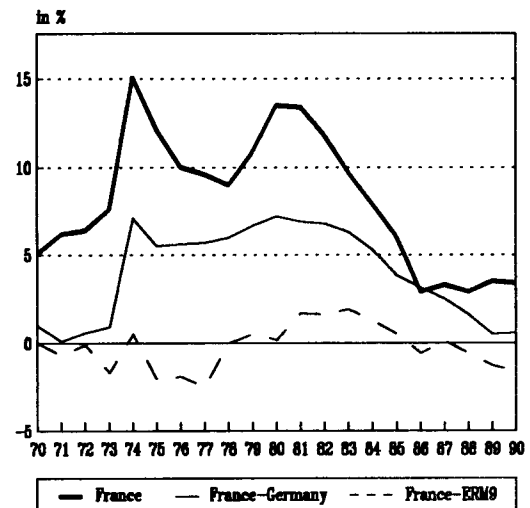
## 1.2 Achievements in nominal convergence

### 1.2.1 The sustainability of the low inflation performance

Disinflation was one of the main achievements of the new policy regime in France in the eighties. As in most other countries, inflation decelerated after the end of the oil price-induced struggle over the distribution of income which was behind the inflation surge of the early 1980s. The slowdown in inflation was more marked in France than in other countries, especially from 1983 onwards. The inflation rate came down from more than ten percent in the early eighties to around three percent in 1989-90; and inflation in France is now well below the average of the ERM countries (Graph 2) pointing to durable achievements in a better ex-ante coordination of the French economy.

Wage moderation has been the main factor behind the disinflation process. A significant deceleration in nominal wage growth together with a satisfactory advance in productivity, has led to a fall in the increase in unit labour costs from 13.5% in 1980 to 1.7% in 1988. During the period 1986-89, unit labour costs actually remained stable contributing to the restoration of higher profitability.

**Graph 2: Inflation rate and differentials  
France, France-Germany, France-ERM9**



ERM9 = EUR12 excl. P, GR and P  
Source: Commission services

### 1.2.2 The current account balance and liberalized capital movements

The interpretation of current account developments in the integrating economies is becoming more difficult. In conditions of liberalized capital markets the current account balance can less and less be considered as a genuine target of economic policy. Better growth prospects combined with strong investment and positive private sector expectations, will undoubtedly have a counterpart in the current account balance. Nevertheless, a persistent current account deficit due to a lack of competitiveness can be considered as an important indicator of future employment prospects. Therefore, the interrelation between developments in unemployment and the current account balance can provide crucial information about the position of the economy.

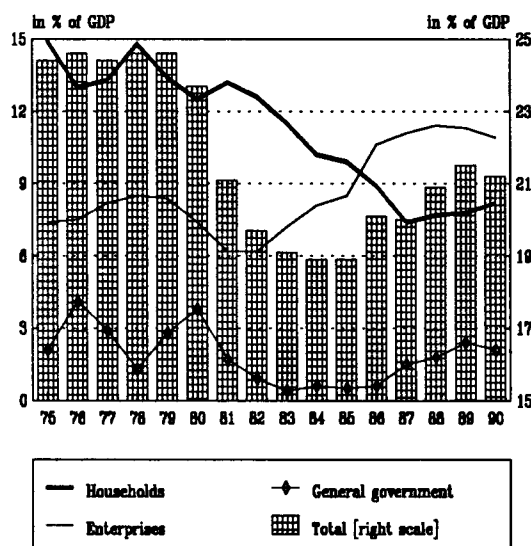
The liberalization of capital movements and the success which has been achieved in maintaining nominal stability have considerably reduced the need for balanced current accounts<sup>1</sup>. To the extent that current account imbalances reflect private sector, intertemporal decisions on saving and investment, a current account deficit could be attributable solely to high investment, reflecting optimal factor allocation in the Community. Moreover, the liberalization of financial markets has reduced the sensitivity of consumer demand to disposable income and increases its responsiveness to changes in the

<sup>1</sup> When capital market restrictions apply, current account imbalances are often sources of exchange rate speculation. Current account surpluses lead to expectations of revaluation and vice versa, possibly irrespective of the causes of such "imbalances". As long as the exchange rate is retained as an instrument for restoring external equilibrium, the current account balance is also an important indicator for economic policy, and thereby influences private sector expectations.

present value of future income, including from tangible assets such as houses and from human capital or financial assets. Therefore, positive expectations increase investment and reduce private sector savings and in such a situation a current account deficit would even be a positive factor as it closes the gap between aggregate demand and domestic production opportunities.

In a world of liberalized capital movements the financing aspects of current account imbalances become of much reduced significance and this is even more the case in monetary union. Nevertheless, such imbalances remain important indicators for assessing the future employment situation. The deterioration of the financial performance of the enterprise sector and a loss in competitiveness due to high wage increases might lead to a larger current account deficit indicating reduced growth prospects.

Graph 3: Domestic savings



Source: Commission services

### 1.3 Economic policy issues

#### 1.3.1 Monetary policy in a market-oriented environment

The macroeconomic framework in France has moved, since 1983, towards giving priority to price stability. Disinflation has been achieved among other things through exchange-rate stability vis-à-vis the DM and a non accommodating monetary policy, based upon increasing role of market mechanisms and budgetary consolidation.

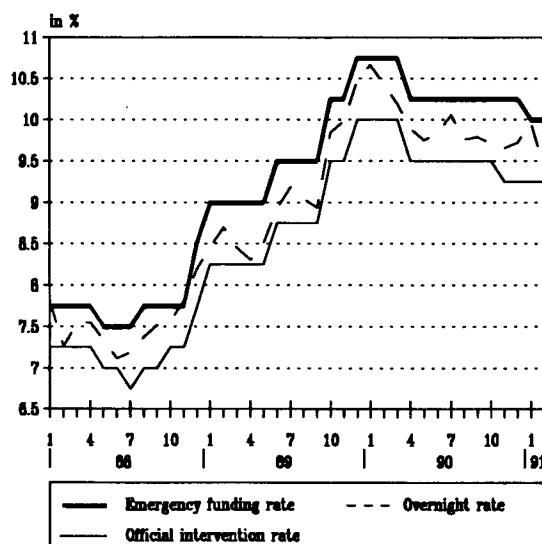
Domestic financial liberalization was a necessary (though not sufficient) condition for the effective exercise of monetary policy. The wide ranging financial reform which took place in the mid eighties was the pre-condition for the liberalization of capital movements

and involved essentially the deregulation of markets and the abandonment of credit selectivity and rationing. Within the banking system, real interest rates which had remained at artificially low levels became higher in response to market conditions. Together with the removal of market segmentation this made possible a better allocation of resources through a more efficient selection of investment projects across sectors and individual enterprises. Ultimately, this contributed among other things (in particular real wage moderation and an increase in the capacity utilization rate) to the increase in the rate of return on physical assets.

In this market-oriented environment, monetary policy was better able to accomplish its anti-inflationary function, via providing the correct signals and effectively transmitting instrumental changes into the monetary sphere. The basic guide of the new monetary policy was exchange-rate stability, focusing mainly on the maintenance of the bilateral parity with the DM, the anchor currency. This contributed to a significant improvement of nominal convergence, strengthened disinflation and provided credibility to French monetary policy. Indeed, a remarkable degree of stability against the DM has been achieved since the end of 1987.

Using market oriented instruments, mainly the two official rates (see Graph 4), monetary policy faced a number of internal and external shocks. Those mainly reflected exchange-rate tensions linked with either problems of credibility and sustainability or with changes in interest rates abroad and, more recently, with financial innovation and integration. In particular, since 1987, the exchange-rate commitment led to a number of changes in official interest rates. Ultimately, the readiness to withstand exchange rate tensions by moving interest rates increased the credibility of the hard currency option.

Graph 4: Official and overnight rates



Source: Commission services

While pursuing interest-rate management, the French authorities publish a yearly target for money growth. Although constrained by the exchange-rate commitment, such targeting still serves to convey to the markets the determination of the monetary authority. In addition, it is useful as a starting point for a closer coordination of monetary policies in the European Community.

**Table 1: Targets and outturns of monetary policy**  
- annual % change -

	1986	1987	1988	1989	1990
M2	3 - 5	4 - 6	4 - 6	4 - 6	3.5 - 5.5
Outturn	4.4	4.2	3.9	4.3	-0.5

Source: Banque de France

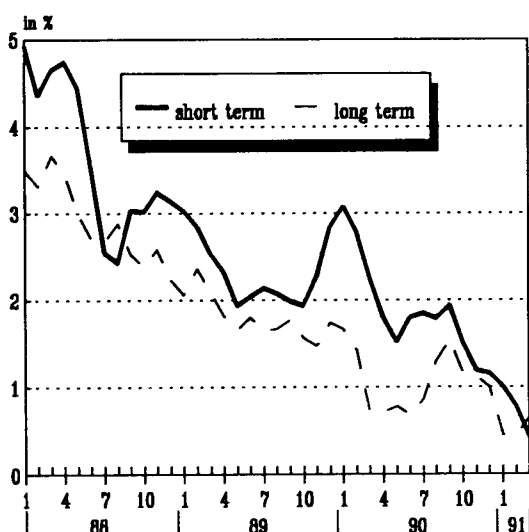
Until 1989, the performance of monetary targeting was by and large satisfactory; indeed, outturns were consistently in the lower segment of the target range. In 1990, financial innovations and an unexpected switch towards assets not included in money aggregates upset the development of the intermediate target variable. Combined with the prevailing monetary conditions and with the need for a greater mutual compatibility of European monetary aggregates, this prompted a reform in the definitions of monetary aggregates in France and a change of the target variable from M2 to M3.

Reserve requirements were upgraded as a tool of monetary policy during the second part of the eighties and were used on a number of occasions, mostly in combination with changes in interest rates. In principle minimum reserve requirements constitute an implicit tax on financial institutions. Therefore, they involve the danger of financial disintermediation or dislocation, i.e. financial transactions take place outside the banking system or abroad where such tax does not exist. Such transactions cannot be easily controlled by monetary policy. To the extent that minimum reserve requirements are considered to be useful in the conduct of monetary policy, the implied tax burden has to be neutralized (in Germany, for example, banks have privileged access to central bank money at below market rates via discount facilities).

However, with such neutralization missing, the completion of financial liberalization since the beginning of 1990, together with financial innovations, resulted in large scale dislocation of savings and forced the authorities to reduce the reserve ratios very substantially. This casts more doubt on the usefulness of reserve requirements as a tool of monetary policy in fully integrated financial markets and points to the need for some harmonization in the Community.

On the whole, both long and short rates, nominal and real, have increased since 1988. They peaked at the end of 1989, under the influence of a generalized rate increase in the Community combined with unfavourable

**Graph 5: Interest rate differentials**  
France-Germany



Source: Commission services

expectations based on internal developments. Since then, the attenuation of expectations that German unification and the disappearance of the iron curtain would lead to a swift demand-increase on world capital markets inducing strongly rising interest rates, compounded with durable installation of better inflation performance, allowed a remarkable reduction in French rates.

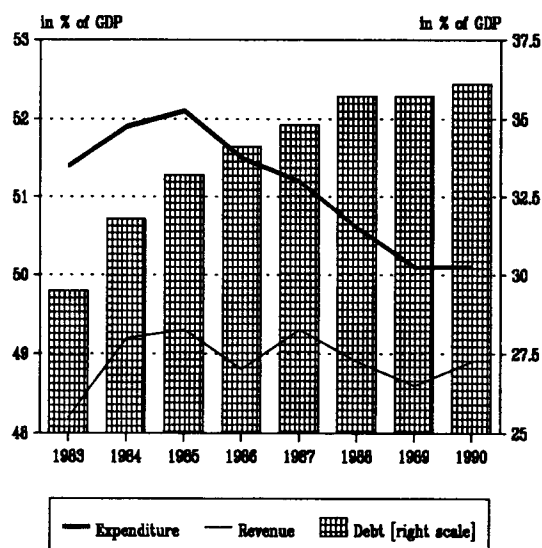
The most impressive results of French anti-inflationary policy can be seen in the drastically reduced interest rate differentials indicating a virtual disappearance of the relative risk-premium. Largely policy-determined short-rate differentials between the FF and the DM, which were as high as 5 points at the beginning of 1988 were down to less than half a point in March 1991. Long rates, which to a much larger extent reflect market appreciation, followed a similar path.

In addition, yield curves were flat and even inverse shaped in recent months, pointing to a high degree of credibility that the anti-inflationary stance of French monetary policy has acquired. It should be noted, however, that another (not mutually exclusive) explanation cannot be ruled out: that earlier enthusiastic expectations about medium term growth and profitability may have subsided somewhat.

### 1.3.2 Fiscal policy

The basic aims of supply-side oriented fiscal policies are to reduce the share of public expenditure in GDP and the saving absorbed by the public sector and to contribute to competitive disinflation. As tax pressure is very large in France, reducing taxes reflects a supply-side improvement by itself, crowding in investment and influencing private sector expectations positively. This objective has

Graph 6: General government finance



Sources: Commission services

been pursued through reductions in company tax rates and in employment taxes, as well as through cuts in VAT rates and in taxation of savings. Despite the cuts in the corporate tax rate, brought down in steps from 50% in 1985 to 34% in 1991 for reinvested profits, taxation of corporations is still heavy and further progress is necessary not least to cope with the challenge of the internal market.

The guideline of fiscal policy is to stabilize the debt/GDP ratio and even to reduce it if possible. Until now, fiscal adjustment has been achieved by reductions in public expenditure accompanied by smaller cuts in revenue. As a result, general government expenditure was reduced by two percentage points between 1985 and 1990 and the deficit declined from 2.9% to 1.2% of GDP in that period. Although this allowed central government debt to be almost stabilized, developments of social security and local administration finances are rendering such stabilization more difficult at general government level. Nevertheless, by international comparison, public debt in France is at a low level.

In 1991, fiscal policy in France remains tight, automatic stabilizers will work only partially which will lead to a small rise in the budget deficit as compared to the initial forecast. It is not impossible that the 1991 budget deficit will turn out in the same order of magnitude as in 1990. On the whole, the aim of reducing the public sector absorption of savings is succeeding. In order to avoid an expansionary swing of fiscal policy in France, any further reduction of indirect taxes or social security contributions should be accompanied by expenditure cuts.

### 1.3.3 The saving ratio and current account balance

The necessity to reduce public sector deficits partly relates to developments in the balance of payments. Indeed, the current account deficit, although small in size (below 1% of GDP), is persistent and increased further in 1990. This could be perceived as a symptom of insufficient national saving, particularly in view of the spectacular fall in the household saving ratio during the last decade despite significantly rising real interest rates. The decline in the saving ratio of private households could also have been partly influenced by the decelerating inflation, reducing the need to adjust the stock of financial wealth. Moreover, the availability of consumer credit together with more favourable private sector expectations might have contributed to the market-induced fall in the saving ratio after 1985.

Nevertheless, the question remains as to whether private sector saving is distorted by the tax system. In this respect, taxation of savings and undue incentives provided for residential construction might affect the financial balance of private households. Indeed, measures taken in 1986 had a considerable impact in favour of residential construction.

It is in this context that the government underlined its determination to stick to a low projected budget deficit in 1991, despite the current economic developments which render the achievement of this target more difficult. At the same time, a number of fiscal measures have been taken with a view to encouraging savings and corporate investment.

### 1.3.4 The ERM constraint: An assessment

After the excessive fiscal expansion and devaluations of the early eighties, the main concern in the period 1983-1987 was to restore credibility and reduce inflation. In the subsequent period up to 1990, with low inflation and high unemployment, the external environment favoured the necessary growth and ERM participation was no obstacle. Faster growth would, perhaps, have revived inflationary pressures.

Since mid-1990, constraints have been appearing. In the second half of that year, fears of an ongoing tightening of monetary policy in Germany did not allow as strong cuts in French interest rates as the authorities might have wished. The present economic situation gives a new dimension to the ERM. The consistent and resolute anti-inflationary stance of French monetary policy, combined with increasing uncertainties surrounding German monetary conditions, could cause a shift in relative credibility. Indeed, the inflation differential might be inversed and it should not be excluded that interest rate differentials might also be reversed. Such a development would first be guided by market forces; thus room for manoeuvre for reducing official interest rates should be used cautiously.

## 2. Micro-economic performance of the French economy

### 2.1 Structural performance: an assessment at macroeconomic level

The importance for the European economies of improving their underlying economic structures is widely recognized (viz the two-handed approach to economic growth): structural reforms aimed at increasing the flexibility of the economies expand their potential and thereby the capacity to create employment without upsetting other final or intermediate targets.

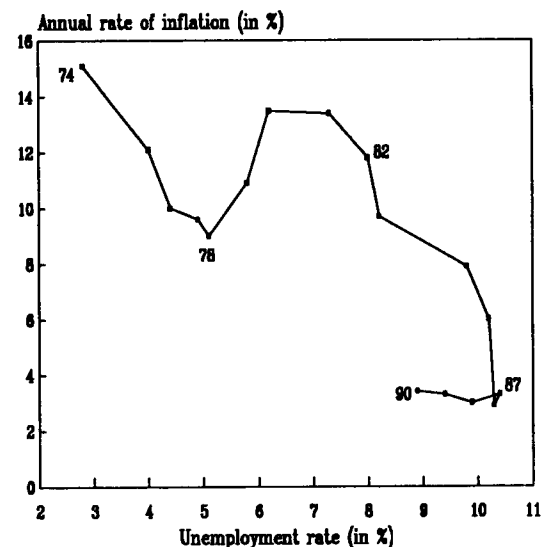
By defining a structural improvement as an increase in the capacity of an economy to simultaneously reduce major economic imbalances, one may identify three distinct sources of improvement. Firstly, microeconomic reforms may be aimed at changing the incentive structure of the economy, thereby directly altering the behaviour of agents. Secondly, the behaviour of agents may indirectly be affected by changes in the macroeconomic policy regime. A relevant example for France is the switch to a hard currency stance and tighter fiscal policy imposing discipline upon agents. Thirdly, changes in the external environment often have significant impacts on major economic imbalances. Thus, lower oil prices may in the short to medium term simultaneously reduce inflation and unemployment as well as improve the current account balance. And increased world trade could in the short term reduce the costs in terms of unemployment of improving the current account balance. However, only improvements of the two first categories are of a genuine structural nature in the sense that they facilitate a durable rise in productive capacity.

Formal tests of whether economies have improved their underlying structure are rather difficult to carry out as both the aggregate demand and supply schedules are unknown. Nevertheless, a detailed inspection of the simultaneous evolution of key target variables may provide valuable information on the performance of the economy.

Graph 7 shows that France has advanced strongly in more recent years: the inflation-unemployment performance improved substantially between 1984 and 1987 and unemployment decreased from 1988 onwards. Since then the rate of unemployment has been substantially reduced while the rate of inflation remained stable.

The decline in the inflation rate was even more pronounced than in other countries. An important element behind the significant drop in the rates of inflation during the 1980s was a shift in macroeconomic policies involving tighter fiscal policies and (except for the UK) a hard currency stance based on strong ERM commitments. It has long been recognized that the benefits, in the form of a stable reduction in the rate of unemployment, of such a change in the policy regime could take

Graph 7: France: Inflation and unemployment



Source: Commission services

years to materialize, essentially because it is based on a reputation for sticking to announced policies, which has to be gained over time.

Although it is difficult to conclude which of the three above-mentioned sources of structural change are most important in explaining the improvements recorded during the 1980s for the smaller ERM countries (NL, DK, B) and the UK, it is probably fair to say that a part of these improvements have been induced by the tight policy stance embarked upon by these countries in the early 1980s. Conversely, the somewhat poorer performance of France in terms of employment creation could probably be ascribed to a slower response in behaviour of agents to the new regime and/or to the fact that France converted to the new policy regime somewhat later (than notably the Netherlands). Moreover, France seems to have given priority to reducing inflation. Finally, it has also to be recognized that labour supply was growing more strongly than in the other countries.

In order to continue on the improving trend reaping the full benefits of the new policy regime (the costs have, as seen already, been paid) it is of paramount importance that policies remain tight. Moreover, the process could be accelerated substantially by implementing measures to directly improve the micro structure of the economy e.g. to improve labour market flexibility. Credible announcements of supply-side reforms would have positive effects on private sector behaviour already in the short term. Finally, it should be underlined that due to the asymmetric nature of credibility, any reversal in policies could prove extremely costly: it takes much longer to gain credibility than it takes to lose it.



## 2.2 Labour market performance

### 2.2.1 Introduction

The level of unemployment beyond the short run depends upon the efficiency in the structure of the labour market. The most important factors which explain the structural level of unemployment are:

- the preferences of wage setters between stable real wages and stable employment;
- the extent of mismatch in the demand and supply for skills;
- the extent and efficiency of job search within and across the labour market;
- and, the extent to which institutional features in the labour market impede or encourage the creation of jobs and provide incentives and opportunities for the acquisition of appropriate skills.

There are important associations between mismatch, job search and the institutional framework of the labour market. Institutional features are also important in determining the balance of power (and the distribution of national income shares) across labour and product markets.

In the short-term, unemployment may vary around its structural level as cyclical influences increase or decrease the demand for labour. However, the rate of increase in the demand for labour will eventually be constrained by structural factors because "excessive" demand will lead to acceleration in the rate of increase in prices.

Moreover to the extent that France is integrating into the European economy, in particular as regards goods and financial markets, the labour market performance of an economy has to be assessed increasingly in a European context i.e. relative to the partner countries. Therefore, as labour mobility remains limited, the national (regional) labour markets have to take into consideration external factors.

### 2.2.2 Growth performance and employment

Until the mid-1980s, weak performance of actual as well as potential output appears to be one main factor behind low job creation. Investment in manufacturing fell sharply in 1981 and 1982 to a level insufficient to maintain the current level of potential production of the sector; although manufacturing investment rose again as from 1984, potential output did not recover to the 1980 level before 1988.

However, since 1988, output growth has accelerated substantially. Employment grew at above 1% per year, but as labour supply also grew substantially the unemployment rate only declined slightly.

For the 1980s as a whole, the growth in potential output has been insufficient to absorb the extra supply of labour mainly stemming from an increase in the population of

working age. A crucial issue is whether the labour market itself has been an obstacle to more rapid growth.

Since 1986, the growth of labour productivity has improved not only because of cyclical factors but also due to a better allocation of production factors. Although productivity cannot be considered a priority target of economic policy, in the context of overall macroeconomic achievement a high rate of productivity growth was welcome in many respects:

- it led to rising profit margins necessary to sustain a favourable investment climate;
- nominal wage moderation and restoring a higher rate of return were achievable without reducing real wages;
- and it rendered feasible the move towards the hard currency option without impeding competitiveness and thus export growth.

Real and financial integration of the French economy into the Community will be further facilitated by a favourable overall supply performance within the European internal market. Therefore, real wage growth should be consistent with further improving profit margins, i.e. real wage growth has to be below labour productivity growth.

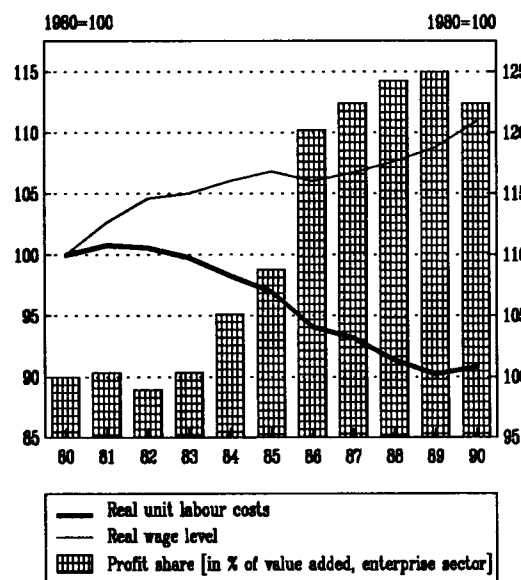
**Table 2: Labour market indicators in France**  
% growth rate - annual average

	70-74	75-80	81-85	86-90	87	88	89	90
Labour force	1.0	0.8	0.5	0.5	0.5	0.2	0.7	0.7
Real GDP	4.4	3.1	1.6	3.3	2.3	4.2	3.9	2.8
Labour productivity	3.6	2.7	1.9	2.5	2.0	3.5	2.7	1.6
Employment	0.8	0.4	-0.3	0.8	0.3	0.7	1.2	1.2
Unemployment rate (in %)	2.7	5.1	8.7	9.8	10.4	9.9	9.4	9.0

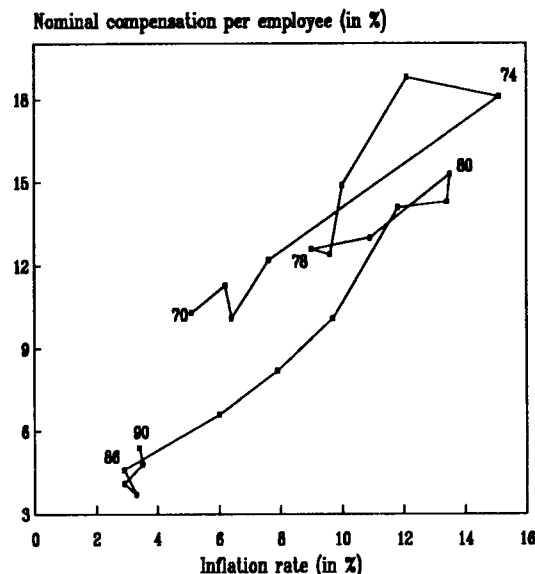
Source: INSEE, unemployment rates from Eurostat

### 2.2.3 Wage formation, nominal stability and employment

The 1980s marked a radical change in the formation of wages triggered by the temporary wage and price freeze in 1982 and since 1983 by wage settlements in the public sector based on the forecast inflation rate. Nominal wage moderation was a principal condition for reducing the short term output costs of disinflation. Real wage moderation was the principal condition for restoring a satisfactory level of profitability.

**Graph 8: Real unit labour costs, real wages and the profit share**

Source: Commission services

**Graph 9: Nominal wage growth and inflation**

Source: Commission services

In the early 1980s, the appearance of market-determined real interest rates led to a considerable squeeze in profit margins which proved to be a significant constraint on investment. Thus, domestic liberalization led to redistribution of income in favour of financial assets, mostly held by private households, to the short term detriment of debtors, the enterprise sector and the state. As real wages rose further in the early 1980s, they did not contribute to the necessary adjustment of real unit labour costs which, in addition, had risen because of the second oil price shock.

During the mid-1980s real wages stagnated and real unit labour costs declined by around 10% over the period 1983-88. Therefore, the terms of trade gain of the oil price drop in 1986 and a large part of the productivity gains led to rising profit margins. However, since 1989, real wage growth has accelerated and real unit labour costs did not decline further.

Nominal wage moderation was a key factor in achieving a high degree of price stability without major frictions on the real side of the economy. Empirical evidence suggests that during the mid-80s nominal wage indexation to past inflation rates loosened considerably, not least due to the move to the hard currency option and its growing credibility (Graph 9). It proved very important that wage earners were not frustrated by higher measured inflation rates as compared to the gradually reduced target rates of the Government, making a major contribution to nominal wage moderation. All in all, the ex-ante target rates became more and more credible, helped, at times, by positive external shocks e.g. the oil price drop in 1986.

In the context of European integration (and in the run up to EMU) external factors in domestic wage settlements have to play a greater role. Both sides of industry should be aware that too high wage settlements not only threaten competitiveness but also the attractiveness of France as a place for investment and thus for job creation. As France has still not achieved a satisfactory level of employment, a positive climate for investment has to be maintained. In order to attain a higher growth path of potential output, real wages in France may have to adjust further.

On the French labour market the statutory minimum wage (SMIC) is a key institutional characteristic. From a purely economic point of view, a minimum wage level which is inconsistent with the level of productivity of low-skilled workers impedes employment and aggravates structural unemployment. The minimum wage level has increased relative to the average wage level, particularly after the oil price shocks when the SMIC increased by 10% relative to the average wage level. Although the minimum wage level is not always binding in reality, an increasing number of wage earners are paid under this regime. Therefore, the wage structure might have become too compressed and too inflexible to absorb low-skilled workers. Moreover, the SMIC impedes regional labour mobility as it is not regionally differentiated. Regional labour mobility is also affected by levies put on sales of houses.

### 2.2.4 Labour market flexibility and policies

In France the environment for a flexible employment policy has improved over recent years. The number of people on temporary contracts has increased. Also public enterprises increasingly behave in a market economic framework and employment in them is to a much lesser extent determined by political considerations. Nevertheless, important impediments to dismissal are still in force, particularly in the area of social plans and retraining programmes.

Labour market policies should aim at reducing labour market rigidities which appear at present to prevent a satisfactory degree of real and nominal wage flexibility, a sensible degree of employment flexibility and establishing a satisfactory use of the capital stock. Moreover, labour market policies can play a crucial role in reducing long-term unemployment.

As regards the use of the capital stock, France should aim at longer running times thus reducing the problem of capital shortage and increasing the productivity of capital. Running more shifts, introducing a 7-day working week and a smoother organization of the highly concentrated holiday period could possibly create a significant number of new jobs. Shortening of working time should be cost neutral and it should be combined with a more flexible use of the capital stock. Part-time working should also be developed in services, which might be particularly beneficial to the reduction of female unemployment.

The re-integration of unemployed people in France may crucially depend upon the significance of the insider/outsider conflict. The insider/outsider conflict suggests that any level of unemployment may be self-perpetuating, because insiders always set wages so as to protect their jobs, but only their own jobs. If, for some reason, unemployment is temporarily raised so that laid-off workers lose their insider status, the new, smaller group of insiders then sets the wage so as to maintain permanently the lower level of employment. In the extreme case where the unemployed lose their insider status immediately, employment and unemployment will show no tendency to return to their previous level, and the unemployment rate will display hysteresis, i.e. the current unemployment rate simply becomes the equilibrium rate. In less extreme circumstances, where the unemployed do not lose their insider status immediately,

unemployment displays significant persistence and may take a long time to return to its previous equilibrium<sup>1</sup>.

The negative externalities of too high wage settlements in the form of higher unemployment are to some extent felt by those in employment via higher social security taxes. However, often this vital link between pay rises and the costs of running the unemployment benefit scheme is blurred by intermediate government intervention. Government intervention to compensate the effects of too high wage settlements on unit labour costs, e.g. by reducing social security contributions, might thus prove counterproductive in the medium term. Although difficult to achieve, a more transparent link may better serve to internalize the externalities for outsiders which the wage setting of insiders involves.

Unemployment benefits in France appear to be fairly generous as regards availability, duration and level. There is, therefore, a relatively strong incentive to prolong the search period for employment and a high risk that workers meanwhile lose important working abilities. Combined with the negative effects of an elitist education system, where too many youngsters leave without adequate professional skills, this probably constitutes an important disadvantage to acquiring employment.

Active labour market programmes have to be devoted to improving the vocational training of young people, increasing the professional flexibility of unemployed people and reducing the insider-outsider problem by keeping unemployed people close to the labour market. All in all, France spends fairly little on such programmes. Other countries' experience (the Scandinavian countries but also Germany and the Benelux countries) has shown that such programmes, if efficiently introduced, can have a positive labour-market effect.

Finally, as regards the education system, the transition from school to professional work is a crucial issue. This primarily concerns technical skills which seem to be underdeveloped relative to general academic skills. The transition from school to professional life is very abrupt and the apprenticeship is poorly developed. It is only recently that large enterprises are beginning to participate increasingly in post school professional education schemes.

1 Although this story is compelling there may be some scepticism about the speed at which unemployed workers become outsiders, but also the hypothesis may be questioned because insiders are assumed to be concerned only with their employment prospects: if insiders also care about their real wages, they should balance their employment target against their wage aspirations. In such a case, a number of other possible factors can affect the persistence of unemployment: slow adjustment in firms' hiring and firing decisions, persistence of wage aspirations of insiders, the tastes of wage setters for wages relative to employment, and the elasticity of labour demand: the membership dynamics explanation of unemployment persistence is simply a special case.

## 2.3 The enterprise sector

### 2.3.1 Assessment of the financial situation of the French enterprise sector

The French enterprise sector has experienced a significant change in its financial performance over the last decade. The improvement in the financial situation is of a qualitative nature rather than being only a quantitative change. Indeed, leaving aside possible measurement errors, profitability including financial gains from debt depreciation<sup>1</sup> is not much above the level experienced in the late 1970s. However, the importance of the main sources of profit has changed substantially.

In the late 1970s, profitability was largely driven by low - at times even negative - real interest rates and a high level of enterprise debt.

In the early 1980s, real interest rates in France were low for three reasons:

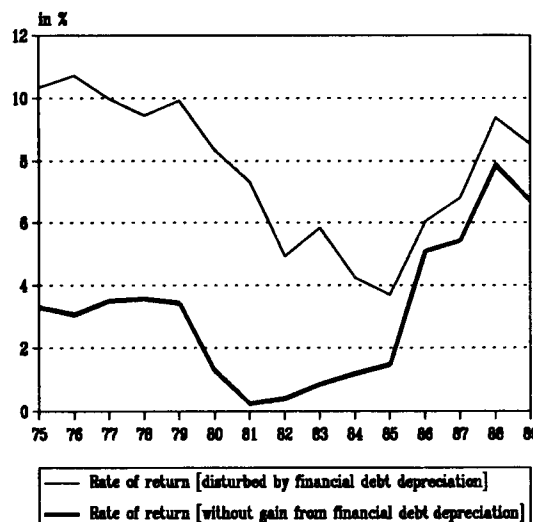
- first, financial markets had been relatively inefficient because of administered interest rates. Quantitative credit rationing and foreign exchange capital controls, which sheltered the domestic market from international capital markets, prevented interest rates from being market determined;
- second, inflation had remained high for several years after the second oil price shock;
- third, the effect of inflation had not been fully grasped by savers so that some money illusion might have persisted.

Therefore, the profits of highly indebted firms were related largely to low (negative) real interest rates and the implied financial depreciation on their financial debt. While profitability (rate of return on equity) (Graph 10) taking into account financial debt depreciation was around 8% in 1980, it was only 1% disregarding financial debt depreciation.

Combined with the impact of controls on bank lending (credit rationing) and the segmentation of credit markets, this led to an inefficient allocation of capital (across sectors and between enterprises) which could partly explain the low level of competitiveness of French companies. The principal factor influencing investment was availability of credit rather than the return on real assets; negative real interest rates and credit controls led to unsatisfied demand for financial resources.

Starting in 1982, real interest rates became positive and the costs of servicing the debt increased considerably. The rate of return on physical assets, however, did not rise in parallel. Consequently, highly indebted enterprises were now confronted by a substantial profit squeeze. During the subsequent adjustment period, re-

Graph 10: Rate of return on equity (own) capital



Source: Commission services

ducing the level of indebtedness, achieving a higher ratio of self-financing of investment and improving enterprise savings by establishing higher profit margins on sales were necessary for enterprises to survive.

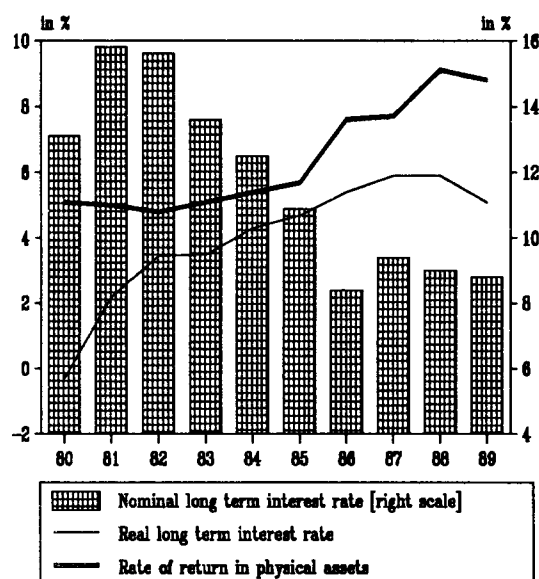
Indeed, during the adjustment period until 1986, French enterprises gradually improved their financial position. The self-financing ratio reached 90% of gross investment in 1986 compared to only 58% in 1980; enterprise saving steadily increased to 7% of GDP in 1989 compared to 4.8% in 1980 and the net debt ratio decreased to 54% (it was about 70% in the second half of the 1970).

### 2.3.2 Capital formation in a market-determined environment since 1986

In the mid-1980s, a structural break took place in the environment in which the enterprise sector operated. In the early 1980s, profitability of the real capital stock was nearly guaranteed by low (negative) real interest rates and investment was mainly influenced by credit rationing and demand expectations. During the mid-1980s, the enterprise sector went through an important liquidity constraint. Since 1986 profitability has increased but in an environment of positive real interest rates. Although the empirical evidence is still vague, it seems that the standard determinants of investment (demand expectations, rate of return, Tobin's  $q$ ) have become more significant explanatory factors for investment during the 1980s.

<sup>1</sup> This return on equity capital is obtained by reducing the net interest payments by the amount of net debt depreciation due to inflation.

**Graph 11: Interest rates on financial markets and rate of return**



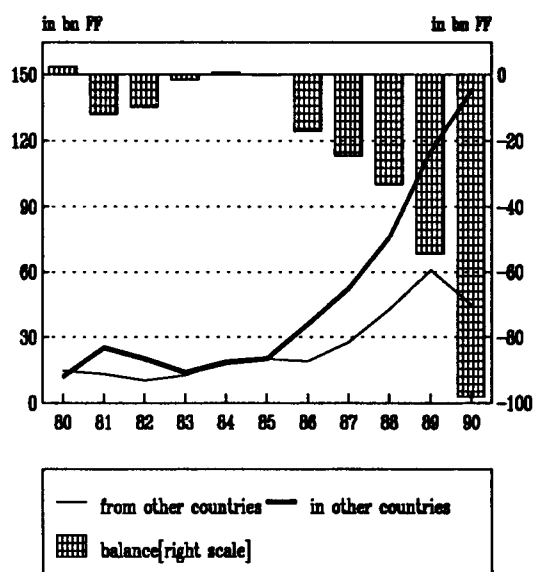
Source: Commission services

Since 1986, on this improved basis, investment picked up considerably. Even more promising, despite historically high real interest rates, the profitability rate was on a rising trend until 1989 (Graph 11). The combination of strong investment and high real interest rates suggests that the expected real rate of return on physical capital is even higher i.e. the real rate of return is competitive with high real interest rates on the financial markets. All in all, France provides a good example, as was also the case for some other countries, of the way in which an appropriate level of real interest rates can contribute to improving the allocation of the factors of production and achieving better competitiveness in the medium term.

The liberalization of external capital movements adds an international dimension. Under conditions of increasing stability of exchange rates the ERM countries are competing on the basis of their respective supply performances. While capital mobility suggests that investment and thus job creation takes place in the country (region) with the highest expected real rate of return, labour is much less mobile across countries. Therefore, in order to ensure a sufficiently high rate of job creation, capital formation has to be attractive at home.

In this respect, France is experiencing a significant gap between direct investment abroad and foreign direct investment at home. Although foreign direct investment flows are welcome in an integrating European economy, the large growth in French direct investment abroad since 1986 has to be compared with the much less pronounced increase of foreign investment in France (see

**Graph 12: Foreign direct investment**



Source: Banque de France

Graph 12). In 1990, French direct investment abroad was around 150 bn FF (more than 20% of domestic investment) while foreign direct investment in France only reached some 50 bn FF (less than 10% of domestic investment). These figures do not take into account the flow of retained earnings reinvested in the host country and, therefore, could underestimate the inflow of foreign direct investment into France.

The growing imbalance in foreign direct investment is probably largely due to a rapid increase of external capital of the French enterprises which has been restricted for a long time (exchange controls, the large appreciation of the dollar between 1980 and 1985).

It would be possible that this imbalance is also due to a lack of foreign investments in France, despite the very favourable macroeconomic environment. The "micro-economic" credibility would thus still be insufficient (in particular the image of "protectionism" which is attached by some foreign investors to France despite the deregulation achieved). Moreover, the constraint on the capital structure of public enterprises has probably prevented foreign enterprises from increasing their acquisitions in France.

Further improvement in the supply-side performance should contribute to the acceleration of foreign direct investment in France thus improving possibilities of job creation and reducing the level of structural unemployment.

### 2.3.3 Investment and the role of the public sector

Discussion of the determinants of investment in France should extend to the role played by the public sector in economic activity. For more than 10 years (1974-86), investment by the "Grandes Entreprises Nationales" (GEN), which comprise firms benefiting from a monopolistic position in sectors considered to be of national interest, accounted for between 20% and 30% of the capital formation of all companies. The increase in their productive capital occurred when their management imperatives were sometimes incompatible with their use as instruments of economic policy. After improving between 1982 and 1985, the return on their assets is now stagnant or falling, with the profitability gap between them and other companies widening (from less than one percentage point in 1985 to more than five percentage points in 1989). That said, social considerations have affected these results, the charges for the services supplied by the national enterprises being set by the public authorities.

On the contrary, the enterprises in the competitive public sector, the managerial independence of which has frequently been proclaimed by the supervising authorities and has been strongly improved throughout the most recent years, have grown substantially. This sector's share of the French productive system increased enormously as a result of the 1981 and 1982 nationalizations. In industry alone (excluding energy), the statecontrolled enterprises virtually tripled in size compared with the sector as a whole, with their workforces rising from 5% to 16% of the total, their value added from 7% to 17%, their exports from 10% to 27% and their investment from 12% to 22%.

Despite the 1986-88 privatizations, the size of the public industrial sector is still well above that before the nationalizations. Investment in this sector still accounts for a high proportion of enterprise sector capital formation also because state-owned enterprises tend to be in high capital intensive industrial branches.

The fact of being state-owned does not appear to have affected the criteria by which these enterprises are managed, even though some decisions necessitated by market developments have been deferred because of the rules governing them, particularly in the employment field. For example, some public enterprises postponed the adjustment of employees in times of a cyclical downturn and during phases of structural difficulties (Renault in the early 80s).

Nevertheless, the legal obligation on the State to retain the majority of the capital of the large nationalized groups may have affected their development and, consequently, the competitiveness of the French economy. The system by which they have increased their equity capital, which is a product not of market logic but of central

government budgetary choices, is likely to have affected their investment decisions. Recent measures to allow private capital to be invested in formerly public owned enterprises are therefore a welcome step to strengthen private entrepreneurship in these enterprises.

## 2.4 Financial markets

### 2.4.1 Introduction

The dominant feature of the financial markets in France during the second half of the 1980s was the extensive financial liberalization and reforms which radically transformed the financial environment. The abolition of the regime of credit ceilings (*encadrement du crédit*), the deregulation of interest rates and the relaxation and finally abolition on 1.1.1990 - of exchange controls were the main ingredients of the financial liberalisation programme.

The parallel progress of European integration, especially in the financial and monetary fields, added a dynamic element and a broader perspective to the process of financial liberalisation.

The deregulation measures were combined with the introduction of an array of reforms and innovations concerning credit, money and capital markets. The adoption of the 1984 Banking Act, the reform of the money market and the creation of a futures market (MATIF)<sup>1</sup> are among the most important initiatives.

### 2.4.2 Macroeconomic aspects of financial liberalization

The macroeconomic policy framework, of which the principal element has been the commitment to the EMS and to a policy of sound money, created a favourable background for the implementation of the financial liberalization programme. This framework affected market expectations positively and limited the risk of excessive movements of interest rates and exchange rates, common phenomena in a period of accelerated financial liberalisation.

The abolition of credit and exchange controls radically changed the design and implementation of monetary policy: in the new environment interest rates became the natural transmission mechanism of monetary policy. The creation of a new interbank market and the availability of a range of financial instruments provided the necessary mechanisms for intervention by the central bank. No evidence exists, up to now, of any disruption of the basic financial relationships following the extensive financial liberalization.

1 *Marché à Terme d'Instruments Financiers.*

The abolition of the restrictions on the movement of capital, a basic component of the liberalization programme, did not have any adverse effect on the balance of payments or the exchange rate. Despite the substantial growth of gross capital flows their movement was in both directions, with largely offsetting effects on the balance of payments. The sharp rise in capital flows combined with a quasi-equilibrium in the current account underlined the autonomous character of the capital movements and the dissociation of the developments of the current and capital accounts of the balance of payments following the financial liberalization and the free mobility of capital.

#### 2.4.3 Impact on financial markets and institutions

The most visible effects of the reforms on the financial sector have been an intensified competition among institutions and markets and the access of firms, households and public entities to a much broader range of financial instruments for borrowing, investment or risk-covering purposes.

Concrete evidence of the success of the reforms is given by the growth of the activity of the new markets. The value of outstanding securities in the money market reached FF 1 237 billion in 1989, from FF 395 billion in 1985, mainly through newly introduced instruments such as banks' certificates of deposit and companies' commercial paper. Interest rate deregulation and the need to cover risk from increased interest rate volatility were at the origin of the creation of the futures exchange, the MATIF, and also explain its immediate success and the market's remarkable growth.

The phenomenon of dis-intermediation, by which direct financing through newly-created financial markets and instruments replaces traditional bank credits, forced banks to adjust their strategies and innovative capability in view of the loss of market share. This change is reflected in the increased proportion of commissions and fees in the total income of banks at the expense of income from traditional financial intermediation business.

One of the most important developments in the new financial environment has been the sharp rise in the proportion of bank credits advanced at market-determined rates. It is estimated that in 1989 65% of new bank credits were market-determined compared to only 1% in 1985. There was also a considerable increase in the share of banks' resources remunerated at market-determined rates.

Two important restrictions concerning credit markets remain.

Firstly, there is the regime of regulated and tax-exempt deposits with savings banks and, correspondingly, the subsidised credits to sectors and activities of high social or economic priority. This is an area where reform seems necessary both for reasons of transparency and effi-

ciency as well as for reasons of compatibility of these arrangements with Community rules after 1992. Nevertheless, the higher market yield of competing financial assets, such as monetary SICAV and recently the P.E.P. (Plan d'Epargne Populaire) are reducing the outstanding amount of this liquid and tax-exempt saving.

Secondly, there is the prohibition on banks paying interest on sight deposits. In addition the cost of payments services they provide are usually not charged. This regulation leads to phenomena of cross-subsidisation of non-profitable by profitable bank services thus contributing to high intermediation costs and in general to a lack of transparency regarding the cost structure of bank services. Moreover, the expected concentration of foreign competition on the most profitable market segments - especially in the post '92 environment of unrestricted provision of financial services - would render unsustainable this cross-subsidisation practice. A review of these arrangements, therefore, appears necessary.

#### 2.4.4 Financial behaviour of corporate and household sectors

The abolition of domestic and external financial restrictions has considerably affected the economic and financial behaviour of the corporate sector. The rise in real interest rates forced enterprises to consolidate their debt level and to rely more on internally-generated funds (improved company profitability helped this) and thus to improve their financial position. This change in companies' financial behaviour was also rendered necessary given their excessive reliance on bank borrowing during the period of low real interest rates and the heavy financial burden this implied when these rates rose substantially following financial deregulation.

Although demand for bank credit resumed strongly after a period of financial consolidation, companies now make increasing use of alternative sources of finance, notably the equity and money markets. In 1990, they raised FF 228 bn of equity capital compared to FF 51 bn in 1984. In the same year, the outstanding amount of commercial paper on the money market reached FF 159 bn, compared to FF 3.3 bn in 1985 when this financial instrument was first introduced.

The availability of attractive alternatives to bank deposits as a result of financial innovation has led to a change in the investment behaviour of households. Between 1980 and 1989 their holdings of securities (shares and bonds) more than doubled reaching 48% of their financial assets (up from 23.7% in 1980), whereas the importance of deposits fell to 37% from 60% in 1980. Recent initiatives aimed at favouring long-term saving such as the PEP (popular saving plan) have managed to mobilize considerable amounts and contributed to a recovery in long-term financial savings.

### 2.4.5 The financial sector and the unified European market

The rapid adjustment of the financial system and the performance of the financial markets and institutions under the competitive conditions following the financial reforms give a measure of the financial sector's considerable potential for an active international presence.

The evidence up to now is that Paris has strengthened its position in the international division of labour in this fast moving and competitive area and ranks second, after London, in Europe. Key financial markets attained the "critical mass" required for the establishment of an international marketplace: MATIF ranks third worldwide with regard to interest rate futures while activity of French collective investment funds, the SICAVs, account for more than half of the overall European market. The strong points of the Paris stock exchange are the new regulatory and supervisory framework, a modernised infrastructure and an efficient settlements system.

The comparative advantage of French banks seems to lie in their solid domestic base with an extensive network of branches as well as their strong international presence, second only to the USA and UK as far as the number of branches and offices abroad is concerned. This international presence was strengthened recently, as shown by the sharp rise of foreign direct investment abroad by French banks: ECU 3.1 billion in 1988 compared to FF 1.2 billion in 1986. This considerable growth was probably motivated by industrial strategy considerations in view of the completion of the single market.

Among the relatively weak points of French banks, compared to the most efficient competitors, can be cited their high operating costs - despite the progress achieved in recent years -, the high intermediation costs already mentioned above and low profitability.

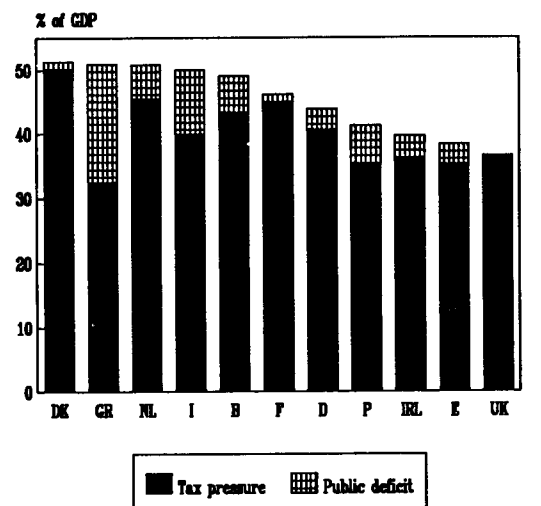
An important point in view of the single market is the capital adequacy requirement for credit institutions following Community directives and international accords (Basle). The major French banks, according to existing indications, have reached or are close to attaining the required ratios. Nevertheless a European and international strategy requires, among other things, a strong capital base. Therefore the need to raise new equity capital appears certain for those banks with ambitions of an active international presence. In this perspective state-owned banks may face difficulties in strengthening their capital base given the limited scope for a capital injection from the State budget.

## 2.5 France: Taxation and European fiscal harmonisation

### 2.5.1 Introduction

As the process of European integration continues towards EMU the issue of taxation will increasingly come into focus. From a macro-economic point of view the share of public expenditures financed by explicit taxes

Graph 13: Tax and expenditure pressure in Community countries, 1990



Source: Commission services

The tax pressure is proxied by the sum of indirect taxes, direct taxes and social security contributions.

is important for the stability of the monetary union as both monetary financing and excessive accumulation of public debt must be ruled out. On the micro level, tax incentives are important for at least two reasons. Firstly, mobile production factors will be responsive to different tax treatment. Secondly, because EMU will alleviate the current account constraint, tax rules that distort investment and saving decisions may have pronounced and persistent effects on the current account balance.

Measured as the sum of direct taxes, indirect taxes and social security contributions, overall tax pressure has decreased slightly in France since 1987, but remains significantly higher than at the beginning of the decade. It is also higher than in most other Community countries (only exceeded by Denmark and the Netherlands) (see Graph 13). Nevertheless, international comparisons depend upon the very different financing system of the social fabric.

It is widely recognised that high tax pressure leads to negative supply effects by distorting the allocation of factors (which, of course, has to be set against the value of the public expenditures they finance). For a number of reasons, however, the (explicit) tax pressure gives a biased indication of tax distortions. Firstly, the micro-incentives of taxes differ according to the specific way they are levied. Secondly, expenditures not financed by explicit taxes also give rise to distortions. Excessive monetary financing of public deficit, by generating inflation has a number of well-known serious consequences for the economy and bond-financing merely serves to postpone the negative consequences of higher taxes - eventually all expenditures have to be financed by taxes. In consequence, tax pressure should also be assessed



against the background of the current budget deficit. In this respect, France stands out as having one of the best budgetary situations in the Community i.e. the fact that France has a high explicit tax burden does not have a counterpart in much higher expenditures than in most other Community countries.

### 2.5.2 Company taxation

Since the degree of capital mobility is far higher than the mobility of labour in the integrating European economy, the level of company taxation is crucial to competitive performance. In France corporations are heavily taxed if account is taken of the whole tax burden. In 1989, the overall average tax burden (without social security contributions and net of subsidies) was 10% of value added compared to around 6% in Germany.

The high rate of social contributions may affect not only the operating results of enterprises, but also the disposable income and spending behaviour of households. Until now, it seems that the wage level has compensated for the high level of social security contribution, thus reducing the effect on unit labour costs. However, the non-progressive rates of social contributions and their ceiling system, still existing for pension contributions, penalise low salary earners. The institution of the Cotisation Sociale Généralisée aims to correct this distortion and represents the first step towards a global revision of the financing of the social security system by a widening of the basis of social contributions to capital and non-salary incomes.

### 2.5.3 Taxation of savings

The Law of Finance of 1989 has substantially revised the taxation of saving in order to make the system consistent with liberalized capital flows and to reduce the tax-induced distortions between financial assets. These new measures have been taken not only to avoid the danger of French saving outflow to abroad, but also to adapt taxation to the new financial products stemming from capital market deregulation.

Previous tax rules have led to financial market segmentation which was inconsistent with an optimal allocation of financial resources. Therefore, the most recent taxation is aiming at the equalization of tax pressure on financial assets. In fact, the income of a large part of French financial saving is not taxed at 18.1% (including 3.1% for social security).

Financial deregulations have led to a progressive decrease in the outstanding amount of savings-bank books (whose interest income is low because it is administered but tax-exempt) at the advantage of competing financial assets, with the same degree of liquidity, but with a higher market yield. The success of monetary SICAV is the proof of this new allocation process by market rules.

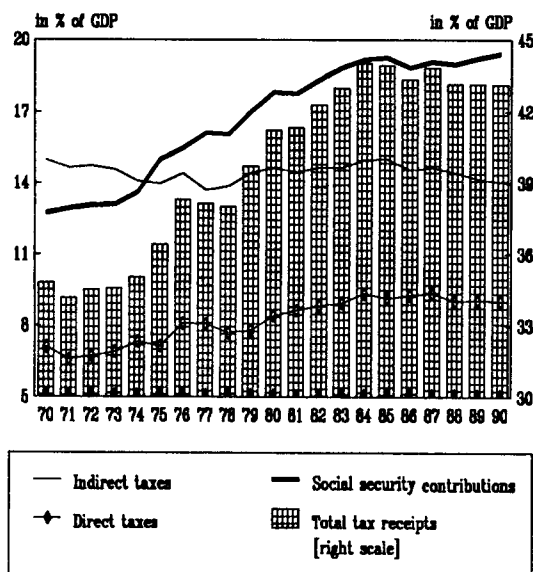
Nevertheless, the size of the outstanding savings-bank deposits still remains high, despite this recent dwindling, and the taxation of distributed profits to stock-holders is higher than taxation of interest income on bonds despite the tax credit on dividends. However, this fiscal handicap on share income has been strongly reduced thanks to a tax rate on capital gains equal to that on interest income (18.1%). This measure has led to the development of the "SICAV de capitalisation", which are allowed to transform the distributed dividends on the shares in their portfolio into capital gains.

To facilitate the financing of investment by long-term financial resources, French authorities have created a new tax-exempt asset, le P.E.P. (Plan d'Epargne Populaire), which allows savers to earn a tax-exempt market interest rate against a long term financial engagement. All in all, these fiscal measures are aiming at the development of financial saving and at its more efficient allocation. Nevertheless, some tax induced distortions and rigidities still remain: they should be reduced in order to allow an efficient financing of productive investment.

### 2.5.4 Direct taxation

Direct taxation of household income was only just over 4% of GDP in 1990. It is an annual tax charged on the total net income of individual households. The progressive tax structure takes account of the dependants in the household (e.g. number of children) and applies to all the various types of income net of deductions, allowances and charges. Income tax revenues grew sharply for 25 years, but slowed down markedly as a result of the series of reliefs introduced in 1985, which brought the top rate of tax down from 65% to 56.8% and extended the system of graduated relief. The effect has been to

Graph 14: Structure of tax receipts



Source: INSEE

take some two million people out of tax altogether, and to reduce the amount of tax paid for a further two million.

In comparison with the other European countries, income tax is of limited importance within the French tax system. This can be explained, firstly, by the low rates charged in the first income brackets (the lowest rate is 5% compared with 25% in the United Kingdom) and second by the narrowness of the tax base. Taking into account allowances and various deductions, the low rates charged in the first income brackets, the system of graduated relief and the exemption from paying small amounts of tax, the tax base is so narrow that many taxpayers do not reach the minimum taxation threshold (48% of French households are tax-exempted).

Because of the high progressivity of the tax tariff in the very high income groups, only high income earners actually contribute efficiently to tax receipt. In 1986, 1% of households declaring the highest incomes paid 27% of tax and 10% of households paid 64% of tax. The tax

rules in force therefore favour low and middle-income taxpayers. However, these conclusions would be qualified if the amount of social security contributions paid was added to income tax.

### 2.5.5 Indirect taxes

Value added tax (net of VAT receipts transferred to the EC budget) represented 7.4% of GDP in 1990, more than one percentage point less than in 1980. The VAT system has been strongly modified as the number of rates has been reduced from 7 to 3 (5.5%, 18.6%, 22%). Moreover, the French authorities have on several occasions lowered the upper rate, bringing it closer to the normal rate. As the other excise duties are on average slightly below the level of other countries, indirect taxation does not require significant further adjustment in view of the internal market.

## PART II

## THE PROCESS OF FACTOR ALLOCATION: ENTERPRISE PERFORMANCE AND THE LABOUR MARKET

### 3. Enterprise performance

#### 3.1 The financial situation and investment behaviour

Since 1983, the French economy has improved its supply performance and at the same time a higher degree of nominal stability has been achieved. Economic policies have aimed at reducing inflation, budget consolidation and stability of the French franc in the ERM. Nevertheless, two main problems remain: the lack of competitiveness of French industry and, especially, the still high level of unemployment, in spite of the improvement in employment in the last years.

The investment performance of the French economy has been strongly influenced by the development in profitability. The level of enterprise debt and the development of real interest rates have played a crucial role. Table 3 clearly indicates that the financial constraints which faced enterprises during the mid-1980s reduced capital formation. The financial constraint was due to the high level of enterprise debt, increasing real interest rates on financial markets which together reduced the rate of return on equity (own) capital.

**Table 3: The level of enterprise debt, the rate of return and investment (non-financial corporate sector excluding national enterprises - GEN)**

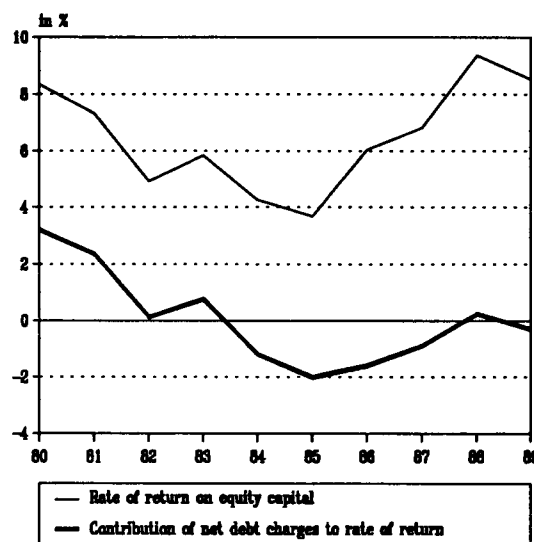
Average	Gross capital format in % of GDP	Level of net enterprise debt in % of equity (own) capital	Rate of return on equity incl. gains from financial debt depreciation
1979-81	7.7	54	8.5
1982-85	6.7	47	4.7
1986-89	8.7	49	7.7

Source: INSEE, Banque de France

Table 3 shows that the rate of return in the late 1980s is not significantly higher than in the early 1980s. However, the structure of returns has changed significantly.

In the early 1980s, profits were mainly due to negative real interest rates on financial markets reducing the cost

**Graph 15: The effect of interest payments on the rate of return on equity (own) capital**



Source: INSEE

of credit-financed investment. Therefore, a large degree of externally financed investment was attractive to enterprises. Given the regulated financial markets, availability of credit was the main constraint on investment. At that time, the underlying or economic profitability of an investment project appears not to have been the primary selection criterion. Therefore, the allocation of capital failed to create an efficient productive system at international level as it prevented the selection of the most profitable investment projects between companies.

In the mid-1980s the rate of return on equity<sup>1</sup> declined because of rapidly rising interest payments. Graph 15 shows that larger interest payments were the major factor behind the decline in the rate of return on equity capital. This negative contribution was due to the combined effect of a high enterprise indebtedness and the emergence of high positive real interest rates.

From 1986, the rate of return on equity capital began to improve. In addition, the fall in real unit labour costs due to both nominal wage moderation and stronger growth in labour productivity improved the profitability of investment. Therefore, while in the early 1980s profits

<sup>1</sup> Rate of return on equity defined as profits after tax and interest payments divided by equity

mainly arose from the distorted financial system, profits of the French enterprise sector now operating in a market economic frame are due to their genuine entrepreneurial activities. Moreover, the decrease in net debt ratio has reduced the effect of increasing interest rates on the profitability of enterprises.

### 3.2 Financing investment: the move to greater self-financing

Financing of investment is important in two respects. At the macroeconomic level, a high ratio of external financing increases the financial deficit of the enterprise sector. To the extent that this is not compensated by higher domestic saving elsewhere, the counterpart would be a current account deficit. On the micro level, high external financing increases the short-term dependence of enterprise profitability on debt interest charges i.e. on the interest rate on the financial market.

Graph 16 shows the significant change in the financing of investment. Since 1985, the self-financing ratio has been around 90% despite the fact that investment picked up significantly. This compares with a very low self-financing ratio in the early 1980s of around 50%. The financial deficit of enterprises thus declined significantly to only 1% of GDP in the period 1986-88 compared to 3% of GDP in the early 80s. This reduced the dependence of the current account balance from investment expenditures.

The marked improvement in self-financing after 1982 was accompanied by a fairly weak investment performance over the period 1983-86. This indicates that companies have given priority to reducing recourse to

external financing in order to stabilize their debt level which has been accumulated during a period of low interest rates.

### 3.3 Determinants of investment

The upheaval in the economic and financial environment was bound to bring about a radical change in companies' approach to capital accumulation from the beginning of the 1980s. It can be assumed that during the previous decade the traditional determinants of investment (the trends of anticipated demand and expected profits) failed to play their normal role because of the distortions caused by inflation to project evaluation criteria (negative real financing cost). Disinflation and market determined interest rates, by contrast, were bound to restore a situation in which prime importance was attached to a company's economic profitability.

Indeed, estimates of stylized investment functions (accelerator effect, Keynesian investment function and Tobin's q approach) suggest that investment is now following market economic behaviour more closely:

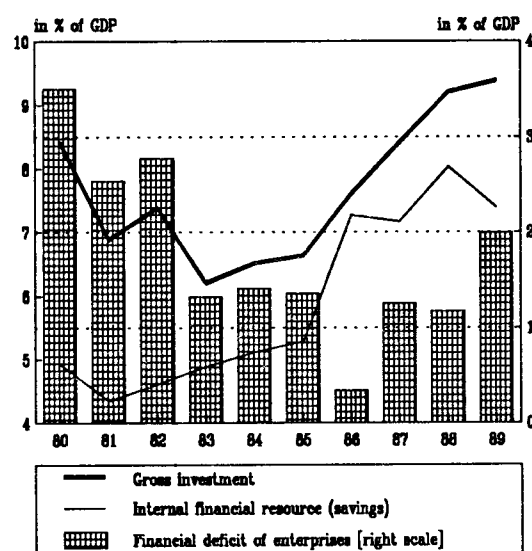
- in the period 1979 to 1985, the accelerator effect seems to have had a low impact on investment. The marked upturn in capital accumulation in 1985 is also not explained by such an approach. Thereafter, the improving rate of return overestimates the rise in investment. This result stems from the aim of enterprises to reduce their debt to the detriment of investment;
- instead, in the period 1980 to 1983 a period of high inflation and, therefore, appreciable financial debt depreciation the rate of return "distorted" by financial debt appreciation provides a better explanation of the capital accumulation.

These accelerator and pure profitability models do not include a definition of anticipated profitability as perceived by the markets. The Tobin ratio, which is equal to the firm's market value defined as the value of shares and debts divided by the capital stock at replacement cost provides information on the anticipated profits which determine the firm's market value (share prices). A high value of this ratio is a sign of good expected profitability and should thus be an incentive to invest.

The effectiveness of this ratio in predicting investment flows depends on the financial market's efficiency in absorbing all the information relating to the firm's profits, including expectations regarding changes to the tax system. This ratio implicitly incorporates the uncertainty perceived through the financial markets.

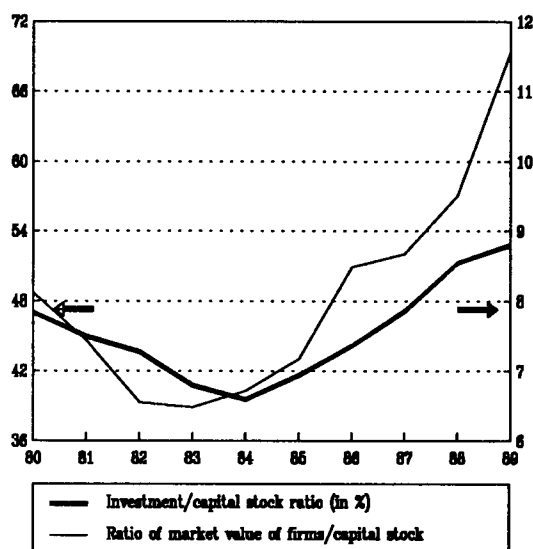
The following graph, which compares "Tobin's q" and the capital accumulation of French companies, shows that the pick-up in investment since 1986 was related to a rapid increase of expected profitability of enterprises which is proxied by the strong increase of share prices relative to prices for new investment.

Graph 16: Investment and the financial deficit of enterprises



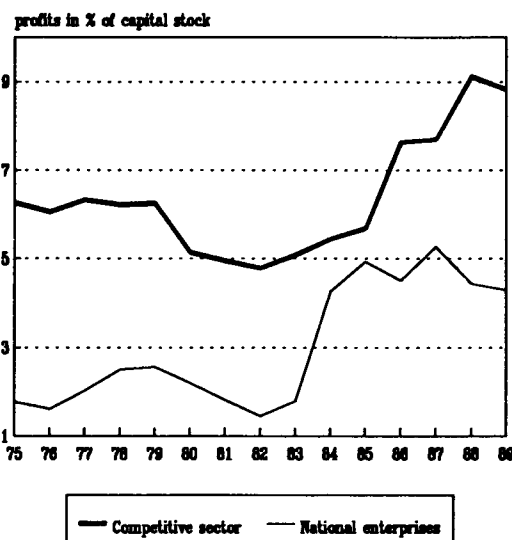
Source: INSEE

Graph 17: Investment and Tobin's q



Source: INSEE

Graph 18: Rate of return of the national enterprises compared to the competitive sector



Source: INSEE

### 3.4 Public enterprises and investment

The existence of a large public enterprise sector in France calls for some qualification of our conclusions, as the profit motive might not be the prime objective of their management.

The public sector can be divided into two entities which differ significantly in a number of respects:

- the national enterprises (Grandes Entreprises Nationales or G.E.N.), which enjoy monopolistic positions in the basic sectors of the economy and which are directly dependent on the State. The national enterprises are concentrated in three key sectors: energy (Charbonnages de France, EDF, GDF), public transport (SNCF, RATP, AirFrance, AirInter) and postal and telecommunications services (PTT);
- the remainder of the public sector (the competitive public sector), which is difficult to define, particularly because of the "cascadetype" pattern of ownership. These enterprises, which generally operate in a competitive market, have been less dependent on State regulation. Although, owing to their public status, they have not had access at the same conditions as the private sector to the capital market. Raising own capital occurred through specific investments (TSDI, "certificats d'investissement"). Moreover, they have not been able to shape their capital (mergers, takeovers, alliances) according to the constraints imposed and opportunities offered by their markets. This reduced their room for manoeuvre and profit margins. Recently, measures have been taken to reduce state intervention by allowing private capital participation.

The economic weight of the national enterprises is still considerable despite its recent decline. Their share of the

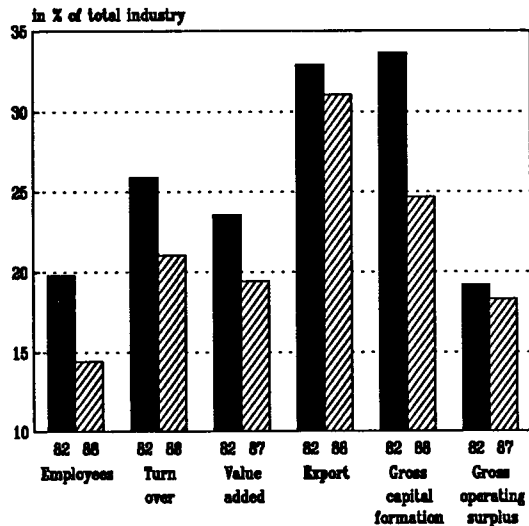
value added of all companies fell from 12.5% in 1985 to 10.1% in 1989. In particular their share in total investment remains substantial (16% in 1989).

Despite the fact that the national enterprises cannot strictly be compared with other companies because of the different approach to their management and their concentration in only three economic sectors, a comparison of certain accounting ratios can help to illustrate the consequences of the abovementioned differences.

In 1975, the rate of return on physical assets (see Graph 18) was more than 4 percentage points below that of other companies (1.8% compared with 6.3%). The gap declined to about 1 percentage point by 1985 and then widened again, reaching more than 6 percentage points in 1989 (2.6% compared with 8.8%). This discrepancy can be explained by three factors: insufficient rationalization of labour use, the high cost of intermediate consumption and political restraint on output price rises.

Although, in general, the share of the competitive industrial public sector declined after the privatization in 1986-88, the contribution made by the public industrial enterprises to capital formation and external trade remain substantial (Graph 19). In 1988, they still accounted for some 25% of total industrial investment (compared with 34% in 1982) and for 31% of total industrial exports (compared with some 33% in 1982). The share of exports in the turnover of the industrial public sector over the period 1982-86 exceeds by more than 10 percentage points that of the private sector (approximately 35% compared with 25%). Instead of becoming blurred with the privatizations, this feature seems to become more marked, with the gap growing over the period 1987-88.

Graph 19: Share of competitive industrial public sector: some key indicators



Sources: SIESI (Ministry of industry)

The rate of investment in the industrial public sector was more than a third higher than that in the private sector, despite a marked fall in 1986 due to the budgetary restrictions on capital financing. As to operating results, as represented by the gross operating surplus over value added, the industrial public sector appears to have been less profitable than the private sector but this performance may stem from the specialisation of public industry in some few branches. However, there is a tendency for the gap to narrow.

3.5 The internationalisation of French enterprises

The French economy is participating in the internationalization of the productive system, which is now a basic characteristic of the world economy. Macroeconomic factors which directly affect the return on capital employed and microeconomic considerations which relate to firms' market strategies and their search for synergies could have led French companies to carry out part of their investment abroad.

The EC and the United States account for most of the investment flows. In 1972, 67% of the total French direct investment abroad went to these areas (40% to the EC); by 1989, this ratio had increased to 84% (62% to the EC). These figures show the growth in the EC's share as recipient countries thanks to successive enlargements and the impact of the 1993 single market. As to foreign investment in France, that from the EC accounted for 35% of the total in 1972, as compared with 7% from the United States. In 1989, the respective figures were 76% and 4%. Over the period 1980-86, the size of the deficit

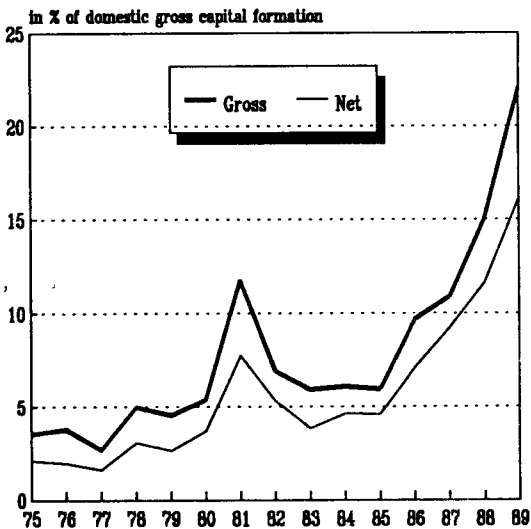
with the United States exceeded that with the EC. United States' investment in France remained static after 1986. The fluctuations in the dollar's exchange rate are one of the determinants of the France/United States balance.

The geographical breakdown of French direct investment in principal EEC countries shows that these countries have all benefited from the increase in the flow of French capital to abroad in recent years, and in particular the BLEU and the United Kingdom. While up to 1986 French direct investment abroad developed more or less in line with foreign direct investment in France, deficits opened up as from 1987, firstly with the BLEU, the United Kingdom and Spain and then with the Netherlands and Italy.

The question of whether or not domestic investment and direct investment abroad complement each other is difficult to answer. While both grew sharply over the period 1986-89, the moderate growth in gross capital formation in France in 1990 contrasted with a sharp acceleration in French investment abroad. The underlying trend in this ratio was one of growth between 1972 and 1981 (see Graph 20). Following a period of decline and stagnation (from 1982 to 1985), it picked up from 1986 and it now exceeds 20% of total investment (as opposed to approximately 6% in 1985).

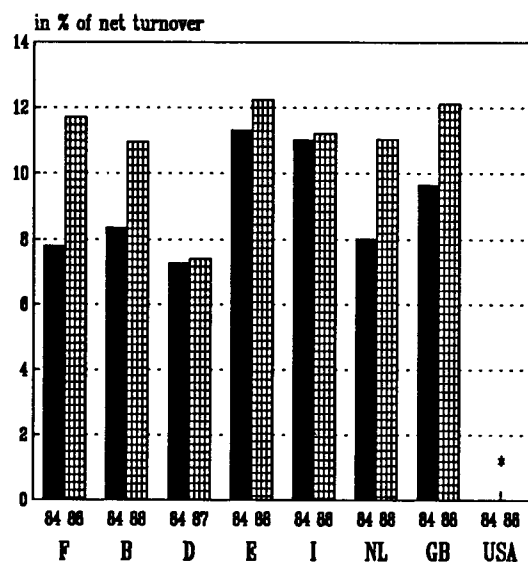
Although it is difficult to make international comparisons, the trend of investment flows abroad as a percentage of gross fixed capital formation increased during the 1980s in many EC countries and in the United States. France, however, recorded one of the sharpest rates of increase from 1986, with an even greater acceleration in 1989 and 1990.

Graph 20: France: Share of french direct investment abroad



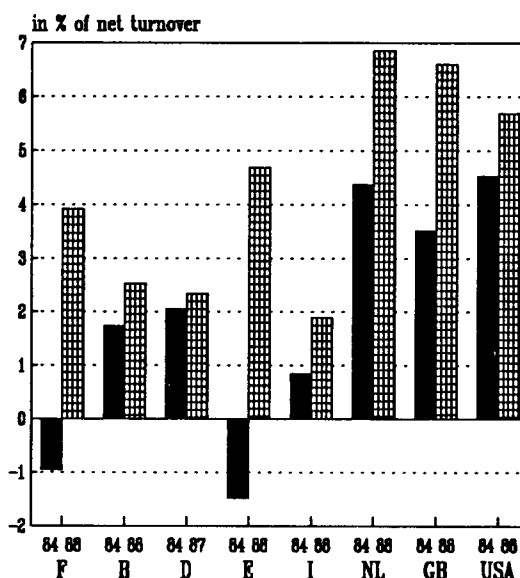
Sources: INSEE, Banque de France

**Graph 21: Profits before tax and interest payments, manufacturing industry**



Source: BACH data bank (EC-Commission)

**Graph 22: Profits after tax and interest payments, manufacturing industry**



Source: BACH data bank (EC-Commission)

As a consequence of the disinflationary process the real cost of financing increased. Therefore, French companies were compelled to seek a higher return on their investment and to adopt a more widening growth strategy to improve their results. Using the ratio of gross operating surplus (gross profits before taxation and interest payments) to turnover as an indicator of profitability in the manufacturing sector it can be seen that the profitability of French companies strongly improved and it was in 1988 at about the same level as recorded in other countries (see Graph 21). The first available figures for 1989 confirm this view.

Among the upstream determinants of these performances, labour costs play a prime role. Therefore, these figures do not explain the growing deficit in foreign direct investment flows. Nevertheless, using the ratio of net profits (after taxation and interest payments) to turnover, it can be seen (Graph 22) that the final profitability of French companies is still, despite an appreciable improvement, below that of many other countries (United States, United Kingdom, Netherlands and Spain). This could result in a low rate of return on equity capital due to a high debt ratio and explain the flows of foreign direct investment in the case of external growth.

What really matters is not the measured rate of return but the expected real rate of return, which naturally depends

upon a wide range of factors. Therefore, the increasing imbalance in foreign direct investment can stem from the existing gap between the achievement of French macroeconomic policy credibility and French microeconomic policy credibility respectively, the former being much more firmly established than the latter.

This situation, which is the opposite of that prevailing in the UK (microeconomic credibility stronger than macroeconomic one), could negatively affect the investment climate. In fact, despite a macro risk premium decreasing towards zero, the micro premium, negatively affected by the image of the micro-economic performance (e.g. the need to further improve labour market flexibility), will require a higher-than-expected rate of return in France in order to attract foreign direct investment.

At microeconomic level and perhaps more important, the growth in French direct investment abroad can be linked to the restructuring of companies, which, after starting in the United States, spread throughout Europe in during the 1980s and was subsequently further amplified by the runup to the single market.

As to the range of productive activities managed by companies, one of the features of the current wave of mergers is that these are directed at seeking productive and financial synergies through horizontal and vertical integration based on the company's primary productive

activity. Indeed, the bulk of French investment abroad involves activities in the French firm's sector of origin.

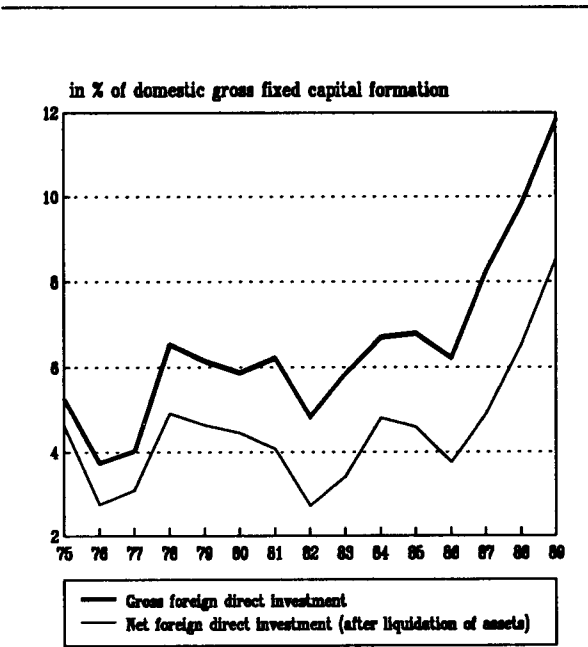
This restructuring process appears to be linked to attempts to achieve economies of scale and the critical size dictated by the growth in general costs (particularly research and development expenses) and to the reduction in transaction costs brought about by synergies within the firm. A study carried out by the Banque de France<sup>1</sup> has demonstrated that the results of companies which have pursued an external growth strategy exceed those recorded by firms which have opted for an internal growth policy, though at the cost of greater vulnerability during the initial integration period.

Although flows of investment into France from other countries have been rising since 1974, that rise has recently been much less marked than the growth in French investment abroad. Not only was the ratio of gross foreign direct investment in France to the gross capital formation of French companies only 12% in 1989, as compared with 22% for capital flows in the opposite direction, but the share of liquidation of investment from other countries has also grown, reflecting some attempts to disengage from the French economy.

An international comparison indicates that the share of foreign direct investment in domestic gross fixed capital formation in France is less marked than in the BLEU and Italy. Only Germany and the United Kingdom record no relative growth in foreign direct investment, at least up to 1988.

The low level of direct investment in France from abroad could be due to a number of factors which relate to financial structure of French companies, to the structure of the French productive system, characterized by a large

Graph 23: Foreign direct investment in France



Source: INSEE, Banque de France

public sector and probably to the image foreign investors still have of France as a very regulated economy, despite the strong recent improvements in this field. The recent measures to liberalize the link between private and public companies might improve the attractiveness of the French economy to foreign direct investment.

1 "L'efficacité des stratégies de croissance externe: l'expérience de l'industrie française", by F. Bavay and D. Beau, Banque de France, 1989.



## 4. Labour market performance in view of the internal market

### 4.1 Introduction

Despite an improved macro and micro economic framework, unemployment in France remains stubbornly high. The rate of unemployment rose steadily until 1987 peaking two years later than the average of the Community. Since then unemployment has declined, but at a slower pace than in most other Community countries. And France is now one of the few countries having a higher rate of unemployment than recorded in the trough of its second oil price recession. Being the principal macro-economic imbalance of the French economy, the relatively high unemployment rate warrants a thorough examination.

The rate of growth of economic activity is an important determinant of the growth in employment. However, the sustainable rate of growth of economic activity (within a monetary and fiscal framework managed for stable prices) depends importantly upon the efficient functioning of the labour market. The level of unemployment is an important indicator of wastage of productive potential. The level of unemployment which is consistent with stable prices beyond the short-run is determined by the structural features of the labour market. The important features include the degree of mismatch between the demand for, and supply of, skills. They also include the willingness and ability of workers to search for jobs within and across local and regional labour markets. They also include the various institutional features in the labour market which may impede the allocation of labour and the incentives to work and invest in human capital. It should be emphasised that the efficiency of labour markets also influences the expectations and ambitions of firms concerning the quality and volume of goods which they are willing to attempt to produce.

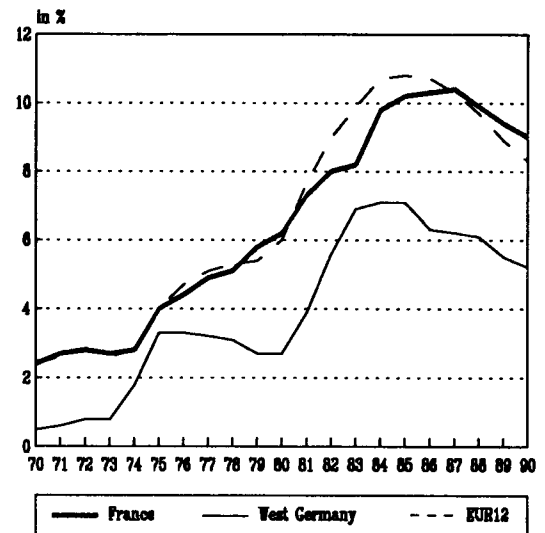
As France is integrating into the European economy in particular as regards goods and financial markets, the labour market performance of a (regional) economy has to be assessed increasingly in a European context. So long as labour mobility remains limited, the national (regional) labour markets have to take into consideration external factors.

### 4.2 French labour market performance

#### 4.2.1 Empirical overview

Unemployment is the principal macroeconomic imbalance in the French economy. Like in all other European countries, unemployment rose steadily in the wake of the first oil price shock, but the reversal did not occur until 1988, somewhat later than in most other Community countries. Recently, unemployment has stabilized at around 9%, indeed a relatively high level. Given the renewed deceleration of growth it might increase this year and next. The poor performance of France in this

Graph 24: Unemployment rates



Source: Commission services

respect is illustrated by the fact that unemployment has remained above the average of the Community since 1987. Moreover, in contrast with most other member countries, unemployment is now higher than the level recorded in the trough of the 1981-82 recession.

A salient feature of French unemployment is its high concentration in specific segments of the labour market. A much higher unemployment rate is observed among less qualified workers (see chapter 5). However, regional differences in unemployment rates are less significant than, e.g., in Germany. Long-term unemployment is very high. In 1989 42% of the unemployed have been without a job for more than one year. The unemployment rate of women is much higher than that of men (around 12% and 7% respectively in 1990). A rise in the female participation rate is mainly responsible for this. However, this is a feature France shares with most other member countries but France has only a low share of part-time employment; Nevertheless, the fairly easy access to unemployment benefits might explain to some extent the high unemployment among women. Youth unemployment is also comparatively large in France. It began, however, to shrink at the same time as in most European countries (1985) partly due, however, to a longer education period. Among the youth, females are again in a relatively worse position.

The high level of long-term unemployment indicates a growing inability of those out of work to (re-)enter the labour market. However, a small reversal was observed in 1989 probably due to a buoyant job creation and to the reinforcement of some specific employment incentives addressed to this category of unemployed.

The remainder of this chapter attempts to illustrate some of the characteristics of the overall behaviour of the

French labour market while the remaining chapters are devoted to an analysis of specific labour market characteristics i.e. the wage formation process, labour market rigidities, the education system and labour market policies.

#### 4.2.2 Labour force and job creation

Due to a marked growth of the population in working age in the 1970s, France experienced a strong increase in its labour force. In contrast to some other countries, the participation ratio even decreased in the 1980s. While the increasing labour force coincides with the small rise in unemployment before the first oil price shock, it contributes to a much lesser extent to the important upward trend in unemployment during the 1980s. Indeed, it was the weak growth performance of the French economy which led to a decline in total employment during the first half of the 1980s.

The interrelation between output growth and the labour force is a complex process. Rising labour supply should normally lead to higher output unless labour markets are inflexible. In addition, rising participation amongst females has important associations with rising vacancy rates: females will enter the labour market if there is an incentive.

Since 1986 economic growth has been accelerating and employment has grown quite satisfactorily. It is particularly promising that employment growth occurred together with a pick-up in productivity, mainly due to cyclical factors but also indicating a better allocation of capital after the process of liberalization during the 1980s and strong investment. Indeed, productivity growth prevented real wages from declining during the phase of nominal wage moderation and allowed enterprise profitability to be restored to a more satisfactory level.

However, the growing number of unskilled unemployed may have led to a higher average level of productivity. If low productivity jobs are crowded out by a too compressed wage structure (see discussion on the minimum wage impact), measured productivity increases to a stronger extent than otherwise. However, this effect is unlikely to explain the whole difference between the productivity growth in France and other high income Community countries e.g. Germany. The major part of the stronger productivity increase in France is probably due to the catching up process which is necessary to prepare France for the internal market.

In this respect, it should also be underlined that at any point in time the choice of technology in industry is often quite narrow. Thus, for a large part of the French indus-

try, higher capital intensity may have been needed, no matter how low wages were.

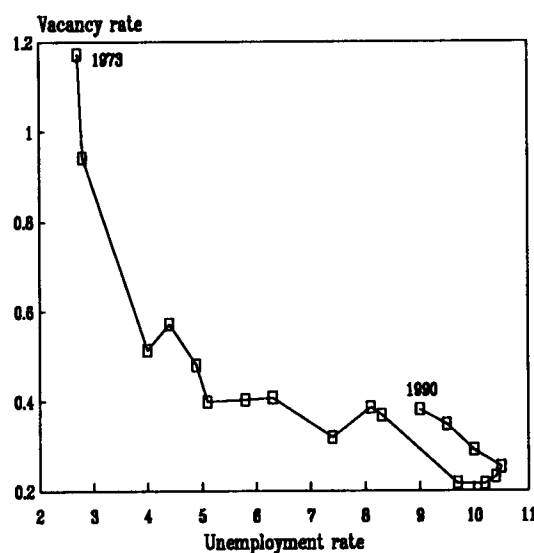
#### 4.2.3 Labour market indicators: some empirical evidence

In theory, the Beveridge curve which traces combinations of the vacancy rate and the rate of unemployment should be negatively sloped. North-east shifts of the curve indicate growing mismatch and may be a symptom of hysteresis<sup>1</sup>.

Although the concept is somewhat unreliable when the vacancy rate is particularly low, the curve has moved to the right in the aftermath of the second oil price shock. The performance of the years 1983-85 and 1986-90 seems to suggest a normal reaction of the labour market i.e. a higher vacancy rate is associated with a lower rate of unemployment.

Labour market behaviour depends upon the degree of competition on goods markets. The greater the competition in goods markets the more enterprises must allocate factors of production efficiently. In particular, the link between labour costs of specific categories of labour and their productivity matters more if enterprises operate in a competitive environment. In France, the domestic liberalization of the financial markets and the emergence of high real interest rates increased the necessity for a

Graph 25: Beveridge curve: France



Source: INSEE

1 Hysteresis corresponds to a lasting effect on the non-accelerating inflation rate of unemployment (NAIRU) after a demand shock which raises unemployment. Basically, hysteresis reduces the deflationary impact of unemployment.

better allocation of production factors. As regards the labour market, the consequence has been that in industry low-skilled workers - who might be expected to be over-paid relative to their productivity have been laid off or have been crowded out by the better skilled. Indeed employment in industry has been on a significantly declining trend during the mid 1980s and this trend has not yet been reversed despite an increase in potential output in manufacturing since 1986. However, declining employment in industry, although less significant e.g. in Japan or Germany, applies in many industrial countries.

The change in employment policy stemming from making goods markets more competitive is reinforced by the fact that employment policy which affected public enterprises through government intervention until the early 1980s is now similar to that in private enterprises.

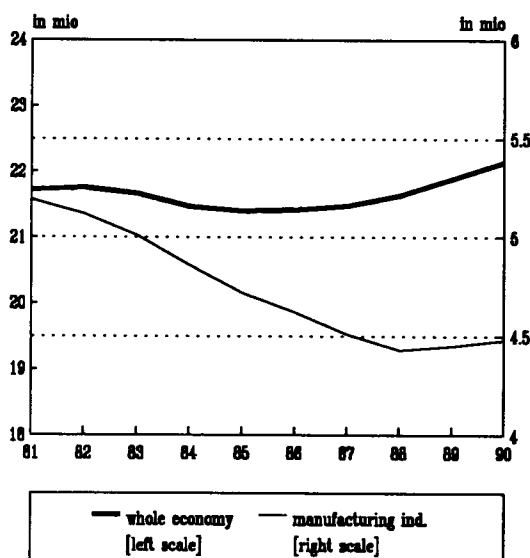
A greater vertical wage dispersion could reduce the mismatch between low skilled workers and available jobs as in particular those workers with low capital investment in skills i.e. youth or females returning to the labour market would have greater opportunities finding a job. In this respect, it should also be recognized that producing with very advanced technologies often also requires

low skilled workers, and that jobs with a low labour productivity can have a very high capital productivity i.e. total factor productivity might rise satisfactorily. The issue of wage flexibility becomes more important in the internal market where investment will take place in an all-European context and attraction of even very advanced technology will also increasingly depend upon the functioning of labour market.

The existence of hysteresis in France has been rejected by most econometric tests<sup>1</sup>. However, for the more recent years, the emergence of an incipient hysteresis in France cannot be entirely disregarded. In fact, after a slow growth for most of the eighties, the already mentioned upward shift of the Beveridge curve seems to suggest some increase in NAIRU<sup>2</sup>. The recent acceleration of wage increases seems to confirm that NAIRU has been growing, getting closer to the actual unemployment rate.

Possible explanations for this incipient hysteresis could include: some "insider-outsider" phenomenon linked to the organization of industrial relations in France (see chapter 4); the high level of long-term unemployment in France, which could tend to increase the NAIRU by reducing the human capital of the unemployed and by discouraging job search; internal adjustments in firms' production practices during the slowdown involving redundancies of workers who are not easily employable elsewhere and which could last even in the upswing.

Graph 26: Employment



Source: Commission services

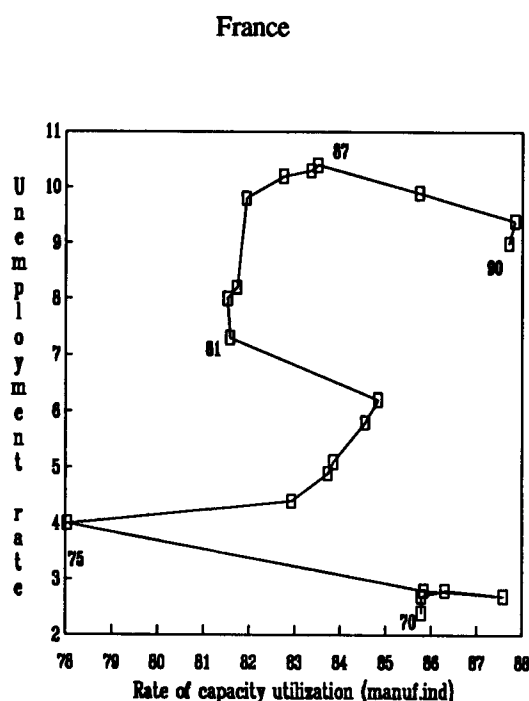
#### 4.2.4 Short-term production/employment dynamics

The short-term dynamic between unemployment and growth (capacity utilization) is a useful indicator of the labour market flexibility during the cycle. A fairly flat curve would indicate that employment does not react very much to short-term fluctuations of production indicating either a strong response of labour supply to increasing labour demand or a rigid employment behaviour of enterprises i.e. enterprises do not adjust employment according to short-term fluctuations of production.

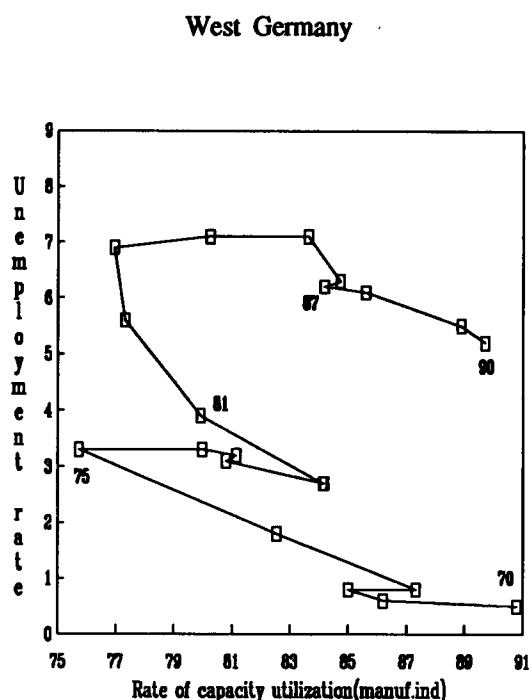
Graph 27 illustrates Okun curves for France and Germany. There seems to be no significant difference in the short-term production - unemployment dynamics in France and Germany. However, Graph 27 also illustrates that the upward shift of the curve has been much more pronounced in France as compared to Germany or the UK over the past two decades. This again suggests that

- 1 R. Jackman, C. Pissarides and S. Savouri, Labour market policies and unemployment in the OECD, *Economic Policy*, 11, October 1990; J.-P. Cotis, F. Mihoubi, l'Hystérésis du taux de chômage en Europe, *Economie et Prévision*, 1990-1/2, using data for the period 1970-1988 or 1987.
- 2 Coe D.T. (1985), "Nominal wage, the NAIRU and wage flexibility", *OECD Economic Studies* No.5, Autumn, estimated the NAIRU for France at 8% in 1981-83, up from 3% in the years 76-80. The OECD, (1989) *Economics in Transition*, and Torres, R. and Martin J.P. (1989), "Potential Output in the seven Major OECD countries", *OECD Working Paper* No.66, put the related NAWRU (non-accelerating wage rate of unemployment) at 5.0% in 1987 up from 3.9% in 1980-83 and at 6.1% for 1980-87, up from 4.4% in 1974-79.

Graph 27: Okun curve for manufacturing industry



Source: Commission Services



Source: Commission services

the growth of potential output has been much weaker relative to labour supply in France than in other European countries. All in all the response of the French economy to the supply shocks of the 1970s (two oil price shocks) seems to have been less favourable than in partner countries explaining the significant increase in structural unemployment.

Since 1988, employment has increased significantly. This indicates that raising output through more intensive or efficient use of the existing work force has its limits, in particular since growth has been solid since 1986.

As the figures show, the demand effects of the first two oil price shocks clearly explain the important rises in unemployment in 1975 and 1981 in France as elsewhere. However, it is noteworthy that the curve is less often negatively sloped for France than for Germany. This suggests that weak demand has played a less important role in explaining unemployment in France. The counterpart is that French unemployment seems to be due more to structural or supply shocks, as shown by the north-east drift of the Okun curve in 1975-80 and 1982-87 (see also Beveridge curve, Graph 25).

As insufficient demand pressure does probably not explain the high level and other features of French unemployment leaves room for other kinds of explanations. One candidate is the possible excessive level of wages.

### 4.3 Wage formation in France: An institutional and empirical assessment.

#### 4.3.1 Introduction

Formally the collective wage bargaining process is not very developed in France, in particular as far as employees are concerned. Trade union membership is the lowest in the EC (about 10%) and it is on a declining trend. Moreover, formal collective wage bargaining has been established fairly late, in 1980 and in 1982 the "Auroux law" aimed at generalizing collective agreements. Moreover, the right to strike is an individual right, i.e. no trade union mandate is necessary. Nevertheless, it seems that high percentages of workers are actually covered by collective agreements. This might

Table 4: Number of hours lost in industrial action per 1000 employees per year

	Germany	France	United Kingdom	Italy
1970-74	40	207	629	1311
1975-79	48	206	509	571
1980-84	51	89	484	830
1985-89	2	41	178	282

Source: Eurostat

explain the ability of certain groups of workers to make strike actions binding and effective.

In recent years, the number of industrial conflicts has declined significantly, as in most other countries (Table 4).

On the other hand, approximately 90% of French companies are affiliated to the Conseil National du Patronat Français (CNPF). Participation in wage negotiations is usually at the sectoral confederation level. Wage agreements are normally made for an undefined time period. Moreover, wage agreements are extended to all workers of the respective sector preventing wage flexibility within sectors.

In France, the state is intervening in the bargaining process, with different degrees of success. Ad hoc intervention, e.g. to expand wage agreements achieved at sectoral level to other sectors were normally more successful than the attempts to establish an effective income policy; one exception was the short period of wage-price freeze during the summer of 1982.

All in all, state intervention is mostly confined to providing recommendations for wage increases. One exception, however, concerns the minimum wage regulations established in 1950. The level of minimum wage is fully indexed to consumer price inflation and it follows real wage increases in industry by at least 50%. Finally, the Government can decide to what extent the minimum wage is raised above the indexed components.

The process of wage formation will become important in the context of both financial and real integration in Europe in order to preserve macroeconomic equilibrium both as regards nominal convergence and also a high level of employment. A larger degree of nominal and real wage flexibility will be required in the process of moving towards fixed nominal exchange rates in order to cope with domestic and external shocks. Therefore, the remainder of this chapter is devoted to analyzing the experience of wage determination during the transition of domestic and external liberalization of the French economy.

#### 4.3.2 Wage development in the course of domestic liberalization

In order to achieve lower wage inflation with a minimum cost of unemployment, it is imperative to break the link between past inflation and wage increases. The French authorities took an active role in this process: in the second half of 1982 the authorities froze wages and prices, followed by a suggestion to link wage increases to the expected inflation rate rather than to past price increases.

Although indexation of wage settlements to expected inflation was crucial in the disinflation process, domestic liberalization and the increase in real interest rates would have required a larger degree of real wage flexibility. Given the high level of enterprise debt, domestic liberalization combined with rising real interest rates has led to a redistribution of income. While the household sector (net bond holders) gained considerably the enterprise sector (highly indebted) was confronted by significantly rising debt service requirements. Despite a change in the functional income distribution (real unit labour costs declined already during the period 1982-84), enterprise profits only increased as from 1984 onwards.

All in all the liquidity constraint was aggravated by low real wage flexibility, which contributed also to the bad investment climate as the real rate of return declined. In this respect it has to be kept in mind that both domestic and international financial liberalization in general leads to a redistribution towards capital income through a more efficient allocation of capital implying a change in the wage share in national income. This does not necessarily require lower wages as the overall growth path of the economy is increased.

Real wages have markedly adjusted to a level which is consistent with a higher level of employment. The wage gap which was mainly due to low real wage flexibility after the oil price shocks has been declining significantly. Nevertheless, recent high wage settlements seem to have stopped the adjustment process. Moreover, three factors might suggest that a continuation of real wage moderation is still necessary. First the increase of real interest rates during the 1980s suggests that a further adjustment of real wages is required; second, in an international perspective, the real wage level in France should be consistent with a satisfactory level of profitability relative to other countries; third, the high level of unemployment requires a higher growth path. Therefore, real wages growth below the warranted wage trend might be necessary in order to achieve the higher growth trend.

#### 4.3.3 Wage development and achieving nominal convergence

During the period 1982-90 France made considerable progress in achieving a low rate of inflation: nominal wages and prices fell in parallel. During this period, it was particularly important that nominal wage settlements were forward-looking to the extent that they were orientated to the forecast inflation rate; and that the inflation outcome did not exceed the inflation rate on which wage settlements were based. Moreover, the target inflation rate of the Government became more and more credible as a benchmark for wage settlements.

The notion of forward-looking wage setting is confirmed by econometric evidence<sup>1</sup>. Estimated wage equations suggest that wages are fully indexed to anticipated rates of inflation. Moreover, the target inflation rate of the government has increasingly been used as a proxy for anticipated inflation, indicating a growing credibility of the government's commitment towards a low rate of inflation.

Monetary policy also achieved a greater credibility in its anti-inflationary stance. No doubt, the monetary authorities' commitment to resist any depreciation pressures since 1987 has significantly contributed to the sustainability of the low inflation strategy.

During this period, France experienced a real appreciation of its currency which helped in the disinflation process. The negative external contribution to growth was mitigated by a healthy investment performance from 1986 onwards. In addition, improving terms of trade helped both in sustaining real income and reducing inflation.

Nevertheless, labour market discipline has also relied upon a high rate of unemployment and is therefore yet to be fully tested in an environment of higher demand and employment. Indeed, recent nominal wage rises are significantly higher than those observed until 1989.

#### 4.3.4 Wage formation in the internal market

Moving towards nominal exchange rate stability in an integrating European economy requires that wage formation increasingly takes into consideration external factors. An appropriate level of wages is necessary to achieve a real rate of return which is competitive with partner countries. Real wage increases must to a large extent reflect those in partner countries, with due respect to national unemployment and productivity increases, while real wage flexibility is required to cope with internal and external shocks.

In the integrating internal market, wage settlements decided at national level are becoming determinants of regional investment. Given the existing low degree of labour mobility between Community countries, inappropriate wage trends together with fixed nominal exchange rates will thus unavoidably lead to larger structural unemployment than otherwise. Therefore, wage settlements have to consider Community-wide conditions, e.g. wage increases in partner countries. In particular, smaller countries with a high export share and quasi-fixed nominal exchange rates (B, DK, NL) already take into consideration wage developments abroad.

In France, the structure of the wage formation process seems to be less appropriate as the level of corporatism is low at the trade union level and domestic factors seem to dominate the preparedness of employers' organiza-

tions to agree on wage settlements. Therefore, the danger that wage settlements do not take into consideration external requirements is greater than in other countries. Nor is the degree of decentralization high enough to ensure that the risk of unemployment is sufficiently felt at individual or firm level and therefore taken into account in wage bargaining.

### 4.4 Labour market rigidities

#### 4.4.1 Introduction

Labour market rigidities prevail on the labour markets of all industrialized countries. The trade-off between social protection of workers and a complete liberalization of labour markets is obvious. One might even say that social protection is a form of non-wage benefit and that the wages of those in work and the social benefits can be regarded as the total wage. Nevertheless, protection of workers can prove to become such a constraint that job creation is reduced and labour protection measures become counterproductive.

Moreover, the degree of social protection in the labour market also depends upon the choices made within a society. To the extent that social protection is counterbalanced by the level of wages, the level of social protection in the labour market might vary among countries.

Nevertheless, labour market rigidities which decrease the efficiency of the labour market should be tackled in order to reduce the most unfair social situation: unemployment.

The following parts aim at identifying labour market rigidities existing in the following areas:

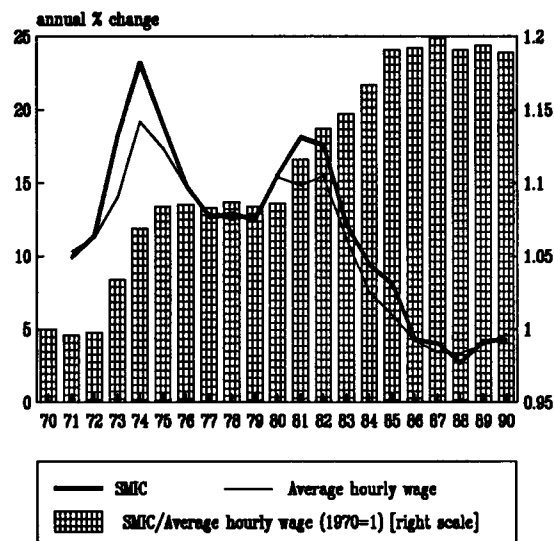
- (i) rigidities preventing nominal and real wage flexibility;
- (ii) rigidities preventing flexibility in employment; and
- (iii) rigidities which impede an efficient use of the capital stock.

#### 4.4.2 Rigidities preventing nominal and real wage flexibility.

One of the specific features of wage formation in France is the minimum wage regulation. Since 1950, France has had an institutional minimum wage (the SMIG or SMIC as from the beginning of 1970). By law, it is fully indexed to the consumer price index, new revisions being triggered by a 2% rise in the index. Moreover, the SMIC is revised upwards every 1 July by at least half of the increase in the real hourly wage rate in industry. It is up to the Government to decide whether and by how much

1 See e.g. Blanchard P. and Sevestre P., 1989, L'indexation des salaires: quelle rupture en 1982? *Economie et Prévision*, No.87.

Graph 28: The SMIC and the average wage level

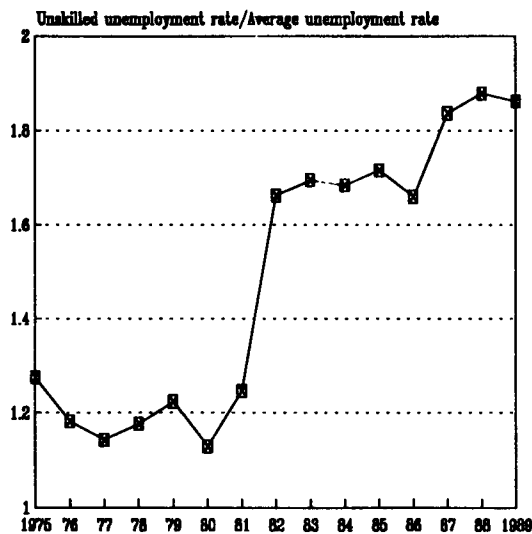


Source: INSEE

more the SMIC is raised. So, it is a true economic policy instrument.

The crucial question, from an economic point of view, is whether the SMIC creates or aggravates the insider-outsider problem. In a situation of rising unemployment, the least-skilled workers are often crowded out by better skilled workers, thus leading to disproportionately high unemployment among the low-skilled workers. To the extent that wage flexibility is particularly low in these

Graph 29: Relative unemployment of the unskilled



Source: INSEE

wage groups because of the SMIC regulation, the crowding out problem is aggravated. The growing number of employees paid under the SMIC regime indicates that the issue might be relevant in France despite the fact that the SMIC is not the binding wage level in all cases.

Graph 28 shows that the SMIC has grown more rapidly than the average wage level. This was particularly the case in the aftermath of the two oil price shocks. In both periods, the SMIC increased by around 10% relative to the average wage level.

The relative rise of the SMIC might have increased the unemployment of unskilled labour. Graph 28 shows that the increase of the SMIC after the second oil price shock, coincides with a significant increase in the unemployment rate of unskilled workers. But also since 1986 unemployment of unskilled workers has increased relative to average unemployment indicating that skilled workers have been more successful in finding a job after the turnaround in growth.

Moreover, the SMIC regulation is also an obstacle to regional labour mobility. As the SMIC is the lower threshold throughout the country, regional wage differentiation is low. Therefore, given differences in the cost of living in particular because of high accommodation costs in centres like Paris, wages net of tax and accommodation costs might be much higher in the small towns and rural areas than in the urban areas. Even unemployment benefits might guarantee a better standard of living outside the large cities, thus reducing considerably the incentives to move to areas enjoying greater economic prosperity. Regional labour mobility would also be strengthened by reducing levies on house sales.

More recently, profit-sharing wage contracts have become more widespread encouraged by a series of government incentives, e.g. reduction in the base for social contributions, less official regulation of profit-sharing schemes. While profit-sharing was negligible in the early 1980s, by the end of 1986 more profits-sharing contracts were agreed upon, and the profit element now amounts to 3.5% of average wages. Profit-sharing increases nominal wage flexibility during periods of shocks.

The way unemployment is financed is likely to affect wage formation. Thus, if the costs of unemployment are felt strongly by the leading wage setters it provides an incentive to take into account the negative consequences their decisions may have for the marginal groups on the labour market. At face value, the system in France seems rather appropriate: about 2/3 of the contributions are borne by the enterprise sector while the employees are paying about 1/3.

Taking all social security contributions together, social security contributions are much higher for low wages, increasing the wage costs for low-productivity workers. Therefore, a broader base for social security contributions might alleviate cost pressures for these workers.

As regards unemployment benefits, the French system is characterized by a fairly generous access to benefits. A

relatively short period of work qualifies the unemployed to receive unemployment benefits. The duration of benefit is from 6 to 24 months. There is no ceiling up to which unemployment benefits are provided and the same amount is paid during the 6 to 24 months period.

#### 4.4.3 Rigidities and employment policy

Rigidities in hiring and firing conditions very often work as an impediment to flexible adjustment of the labour force to production (flat Okun curve). They may also impede a flexible adaptation of production if enterprises hesitate to hire people during a phase of strong demand because they may be faced by too many workers if demand decreases. Therefore, a link exists between strong competition on goods markets and a flexible employment policy.

In France the environment for a flexible employment policy has improved during the last few years. In particular, the possibility to hire people on temporary contracts has been improving and the number of workers under a contract regime has actually increased considerably.

Nevertheless, important rigidities remain. For example, social plans for people about to be made redundant remain a requirement and employers must offer retraining programmes at 70% of the last wage to all employees with at least two years of employment in the respective firm.

In the past, public enterprises have undertaken a cautious employment policy because of social obligations and considerable costs of firing. As the French economy now operates in a market framework after the important steps towards liberalization, a more market-oriented approach to changing the level of employment is called for. State intervention should be confined to defining the framework for employment policy and intervention in individual firms should be avoided.

Liberalization of working procedures may increase the number of part-time jobs available. This could be particularly beneficial to women whose unemployment rate is relatively high. In this respect, monopolized job-mediation (Agence Nationale pour l'Emploi) procedures might also have to become more flexible.

#### 4.4.4 Employment - capital stock relation

In principle, a country like France faced by a shortage of capital could increase potential output by increasing the running time of the capital stock. This would create more jobs with the existing level of capital stock. Therefore, a more flexible organization of working procedures, i.e. running more shifts, a 7-day week operation and a smoother organization of the concentrated holiday period, could create a significant number of new jobs.

However, several conditions would need to be fulfilled. First, working during nights or weekends should not add to unit labour costs; second, a more flexible organisation of working hours of employees should be allowed at the

level of the individual firm and measures should be taken to avoid skills "bottlenecks" in the labour force.

A further issue concerns the possibility of a more flexible use of the capital stock by shortening employees' working time. This should not only concern the weekly working time but also a more flexible organisation of working time over the year or even during the life time. Models of part-time working should be developed in order to reduce female unemployment in particular.

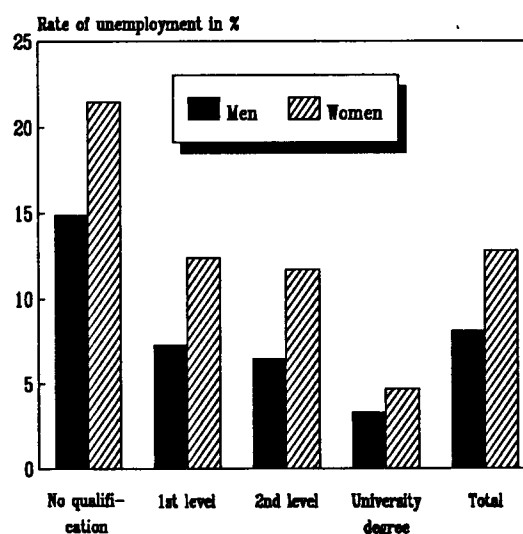
### 4.5 The education system

Educational qualifications of people are important determinants of employment potential. This is particularly evident in the French economy. Youth unemployment is particularly high in France and in the 18-25 years age group where 40% of the unemployed do not have any recognized qualification.

Graph 30 shows a clear link between the level of qualification and the rate of unemployment. The employment rate is close to 20% in the no-qualification group, while people with higher education are much less affected by unemployment.

However, the graph also indicates that within the group with average education levels, the unemployment rate is fairly high. One reason might be that technical skills are under-developed. In the second level stage (age group 10 years to 18 years), the share of the vocational training channel is only 53%, compared with 80% in Germany and 70% in Denmark. Apprenticeship is poorly developed, as compared with Germany. There are 1.8 million apprentices in Germany against only 215 000 in

Graph 30: Unemployment and education



Source: INSEE, enquête emploi



France. Among German apprentices more than 90% obtain a professional qualification and 80% are recruited by their "host" firms at the end of their three-year training period. Less than 50% of the French apprentices obtain a final qualification (CAP, "certificat d'aptitude professionnelle") and an insignificant number are recruited by the firm where they made their apprenticeship.

A significant influence of education on labour productivity is also evident. The average productivity of a worker who left school before the age of 15 is half that of a worker who stayed in the education system until the age of 22 to 24 years. Apparent labour productivity is systematically increased as enterprises employ more engineers and qualified technicians and less non-qualified personnel.

All in all, the general level of education in France is far from being satisfactory. Full-time education is compulsory until the age of 16. If the rate of participation in education at the age of 17 is equivalent to those of other EC countries, it decreases rapidly among higher age groups. At the age of 19, only 43% of French youths are still in the education system as compared to 57% in Germany, 54% in the Netherlands, 53% in Denmark and 49% in the UK.

A serious problem lies in the interface between schools and enterprises. The transition from the education system to the labour market is made more difficult because a vast majority of youth leaving school have no real direct experience of a working environment. Ages of reciprocal misunderstanding or ignorance between the educative and economic worlds need to be overcome culturally in order to approach the "dual" system successfully developed in Germany. Nevertheless, improve-

ments have been observed in the past few years. For example, new types of vocational training implying compulsory periods in firms ("baccalauréats professionnels") have been created.

The orientation of the French education system is quite "elitist". There are significant barriers to entry into different channels of education. In the second level (aged between 10 and 18 years), the general education system is distinct from vocational training and mobility of pupils from one to another tends to be from general education to vocational training. In the third level, the "Grandes Ecoles" which recruit most of their students between the age of 18 and 22 and benefit from the highest expenditure-per-student ratios form a channel completely separated from the remaining universities. This polarisation at the different levels of the system is reinforced by the long-standing Paris-provinces polarisation.

The general picture is supported by comparative statistics. The proportion of any given generation entering university is comparable to that of other EC countries: 33% as compared to 26% in Germany, 33% in the UK, 35% in the Netherlands or 37% in Denmark. The proportion obtaining a 4-year degree and higher qualification is even higher than in all other countries, probably because third level education in the public sector is free. The education system is clearly providing the French economy with a sufficient number of highly qualified workers, for whom the probability of unemployment is very low.

#### 4.6 Labour market policies

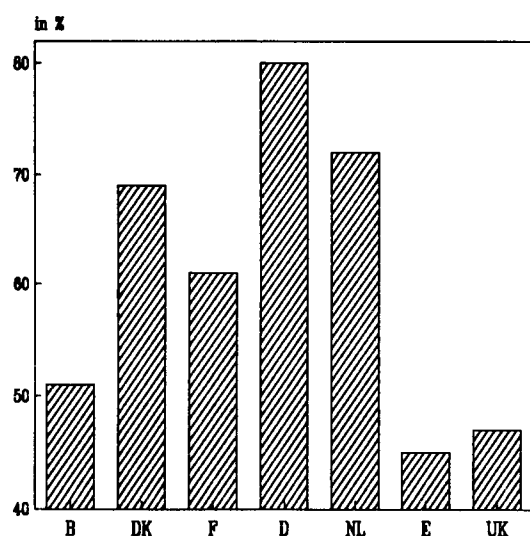
Most Community Member States have been reluctant to adopt active employment policies. Except for public sector wages, intervention in the wage settlement process is minor and is confined to moral suasion. In France, however, the minimum wage regulation is controlled by the Government.

Labour market policy can be divided into active policy and passive policy. Passive policy might consist of early retirement schemes: thus artificially reducing the number of unemployed. Active labour market policies aim at reducing vocational weaknesses, increasing the mobility of workers, and reducing the insider-outsider problem.

Graph 32 compares the level of unemployment with the expenditures of active labour market programmes per unemployed person. Although the success of individual labour market programmes cannot be proved and the unemployment rates depend on a variety of important factors, the graph suggests that countries with active labour market programmes and a corresponding design of their social security system experience lower unemployment rates.

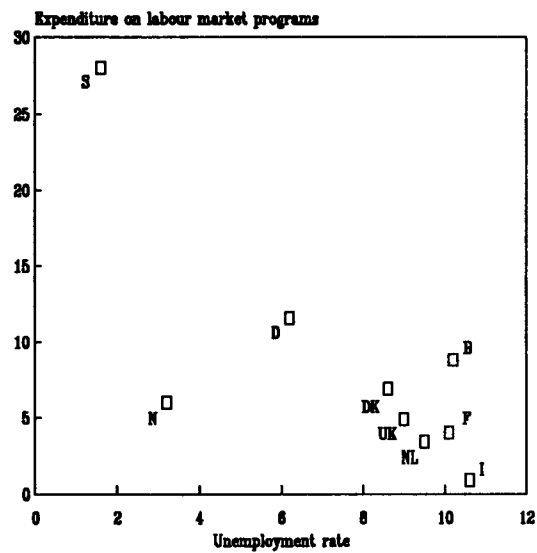
Among the Community countries, France shows a fairly inactive attitude. A closer link between social security

Graph 31: Share of vocational training in secondary school



Source: OECD 1990

Graph 32: Labour market programmes and unemployment in 1988



Source: Commission services

benefits, which are provided fairly easily, and labour market programmes appears advisable.

Labour market programmes should mainly be devoted to the following three areas. Firstly, they should aim at improving the vocational training of young people. Given the abrupt transition from school to work life, young people fail to adjust to the new challenges. Therefore, labour market programmes should aim at improving the professional quality of school leavers and also to provide greater flexibility between professions. Secondly, labour market programmes should increase the professional flexibility of unemployed people in order to prepare them for new jobs. This would reduce unemployment in sectors where employment is on a structurally-declining trend. Thirdly, the importance of labour market programmes for reducing insider-outsider problems should not be underestimated. Participants in such programmes get much more information about their own professional prospects, realistic income levels and the necessity to become more flexible. In order to strengthen the links between labour market programmes and the labour market such programmes should be designed in close contact with the trade unions and the enterprise sector.

## PART III

### FINANCIAL AND MONETARY INTEGRATION: AN ASSESSMENT OF INSTITUTIONAL REFORMS

#### 5. Financial reforms and the liberalization of capital movements

##### 5.1 Main deregulation measures and reforms of the financial system

###### 5.1.1 Introduction

The financial markets in France underwent profound changes during recent years following government's extensive liberalisation programme as well as market originating innovation. The parallel progress in the European integration, especially in the financial and monetary fields, enhanced the importance of the financial liberalisation operation putting it in a broader and more ambitious framework.

The developments in the financial markets affected both the financial sector itself as well as the rest of the economy. The impact of the reforms was considerable in the areas of macroeconomic policy, the structure and competitive position of the financial markets and institutions and on the borrowing and lending behaviour of the corporate, public and households sectors.

An important aspect of the financial liberalisation is its impact on the international financial integration of the French economy, and on the prospects of the financial sector for an active presence in the European and international financial scene.

A basic reason for the movement of the authorities towards the direction of extensive deregulation and reforms in the financial system was the signs of increasing distortions in the functioning of the financial system and of the way financial resources were allocated under the credit ceilings system. The access by certain credit institutions to low cost finance and their parallel exception from credit ceilings led to a rapid growth of their balance sheets and correspondingly of the share of subsidised credits in total credits to the economy.

Privileged credits rose to 44% of total bank credit in 1979-81. Moreover the institutions supplying these credits collected around 60% of total deposits, i.e.: far more resources than was necessary to finance all privileged credits<sup>1</sup>.

In view of this situation and the loss of market share by banks, the authorities allowed them to raise funds on the bond market and exonerate the corresponding credits from the credit ceilings. Though this practice enabled the

development of the bond market it complicated even further the functioning of the system of credit ceilings but also eroded its effectiveness.

Another reason behind the decision of the authorities to abolish the credit ceilings was its incoherence with the new macroeconomic orientation and its implications for the financial markets. The firm commitment to EMS implied a policy of no monetary financing of the budget deficits which in turn required the development of a mature capital market. Moreover decision to keep and respect monetary targets was not compatible with the existence of a controllable part and a growing uncontrollable part of liquid assets.

In addition to the above there was the external constraint in the form of the need to keep in pace with countries having long tradition and established reputation in the financial domain (US, UK) as well as other emerging marketplaces. The authorities responded to that with a move away from the highly regulated and segmented financial system centred on the intermediation of credit institutions, towards a system focused on the existence of a unified financial market, including futures markets, where instruments of all maturities can be traded, and be accessible to all economic agents.

###### 5.1.2 New legal framework for banking activities

The Banking Act of January 1984 served as a background for the subsequent important decisions and reforms that changed the financial landscape in France. It replaced legislation dating back to 1941 and 1945 and brought all credit institutions under one common regulatory framework and under the control of the same supervisory authorities. It removed the old distinctions between commercial banks and merchant banks and a number of other divisions which no longer corresponded to the economic reality. The objective was the creation of a unified banking system in which intensified competition among financial institutions would increase the efficiency of the system.

###### 5.1.3 Abolition of the credit ceilings regime

The abolition of the system of credit ceilings was also announced in 1984 but its elimination was gradual during the two subsequent years. In this transitional period the role of the reserve requirements as a potential shock

<sup>1</sup> See J. Melitz, CERP discussion paper n 509, January 1991.

absorber increased. The credit ceilings system was removed altogether in January 1987.

Though the system was, to an important extent, already eroded as a result of the exceptions and the allowed circumventions, its abolition was nevertheless an event of considerable importance. Regardless of the justification or not of the principles on which the system was based it had become almost unmanageable and lacked transparency. Its abolition marked the end of an era of extensive administrative controls on the allocation of credit to one where market prices would be the principal determinant.

#### 5.1.4 The reform of the money market

The notion of money market in France is much broader than the usual concept of a market for short-term (up to one year maturity) securities. In France money market debt instruments of up to seven years maturity can be traded.

Following the reforms of 1985-87, part of the money market, the interbank market, is accessible only to credit institutions subject to the Banking Act of 1984: this is the market where banks' temporary cash surpluses are allocated to those in need of financing.

The new money market in the largest sense was designed to accept the biggest possible number of participants and to offer a complete range of instruments and maturities. It aims also to attract international investors interested in placing their money in a well organised and liquid market. Securities first introduced in December 1985 include: certificates of deposit issued by banks, commercial paper issued by enterprises, negotiable Treasury bills, bills of specialist financial institutions, etc. A step towards an increased internationalisation of the money market was the opening up, in January 1991, of the commercial paper market to non-resident issuers.

#### 5.1.5 The bond market

The major reforms of the bond market concerned three areas: the organization of the trading, the reform of the borrowing techniques of the Treasury and measures to improve market's liquidity.

The introduction of 13 primary dealers in government securities (*spécialistes en valeurs du Trésor*, SVTs) in January 1987 was a measure aimed at improving the functioning and notably the liquidity of the market. Moreover the capital of brokerage houses was opened to banks or other agents. The "dematerialization of securities" was another innovation introduced in 1984. This implies in practice that the transfer of securities is effected through a registration in the books of an official clearing company (SICOVAM). the benefits of the new system lie in a higher security of transactions and lower cost of portfolio management.

Concerning government borrowing the most important changes concern the introduction, since July 1985, of a

Dutch style auction system for the selling of government securities, which replaced the old system of placements through a bank syndicate. One significant aspect of this technique is the abolition of fixed commissions to members of the banks syndicate, a feature of the old system, and thus a lower borrowing cost for the Treasury. Another aspect is that it contributes to the creation of orderly market conditions by the pre-announcement of the time-schedule of the auctions, including amounts and general terms. Lastly, an important innovation introduced in June 1985 consists in the standardisation of bond issues and thus the improvement of market liquidity by the introduction of fungible Treasury bonds (*obligations assimilables du Trésor*, OATs). More recent developments of the bond market are given below.

#### 5.1.6 The MATIF

The MATIF introduced in February 1986 as "*Marché à terme d'instruments financiers*" and renamed in 1988 to "*Marché à terme international de France*" is an integral part and important mechanism of the new market-centred financial environment: financial liberalization and deregulation increased the risks arising from the higher interest rate volatility and the need for a market to assess and cover this risk. The success of MATIF was immediate since it was first established and it ranks among the largest worldwide in trading volume.

### 5.2 Impact of financial liberalization on markets and institutions

The impact of deregulation, financial innovation and reforms on the financial system was considerable. The dominant position of banks and specialised credit institutions in the financial intermediation business was put under threat in the new competitive environment where alternative forms of finance have become available.

The phenomena of financial dis-intermediation (by which direct financing through the financial markets replaces bank financing for increasing number of borrowers) and securitisation took considerable proportion in France during the financial liberalization process and are signs of intensified competition and financial innovation. Banks' response to this loss of market share was an increased engagement in the securities business as underwriters and placement agents. The increasing role of banks in this market segment is reflected in the composition of their income: the share of commission and fees has increased considerably (up to 25% or even higher for certain large banks) at the expense of income from traditional intermediation business.

The increasing share of market-determined rates in banks' sources and uses of funds is one of the most important developments in the new financial environment.

**Table 5: Share of resources collected on market-determined rates- (% in total)**

	1979	1989
Credit institutions	25.4	44.8
- banks AFB	20.9	50.0
- mutual banks	30.6	34.2
- CDC & savings banks	5.5	15.7
- finance companies	77.4	88.2
- specialised financial institutions	89.7	97.7
AFB: French Bank Association		
CDC: Consignations and Loan Fund		

Source: Banque de France

The share of funds collected by credit institutions on market-determined rates during the 80's rose from 25.4% to 44.8% of their total resources. This rise is partly attributed to the higher proportion of banks' fund raising through the issue of securities. Despite this considerable increase more than half of the resources of credit institutions are still (end 1989) collected on regulated rates. This phenomenon is due to the non-remuneration of demand deposits and the fact that most liquid savings are regulated.

On the banks' assets side, 65% of credits were at the end of 1989 allocated on market-determined rates (i.e. rates indexed to those on the money market) compared to only 1% as recently as 1985. Regarding the outstanding amounts of credits it is estimated -no exact data are available- that the share of market-determined credits in total is close to that of banks' resources, a factor reducing the risk of financial instability in case of interest rates fluctuations.

Regarding the competitive position of the banking sector, the impact of its increasing integration with the European and international financial system and the intensified competition was also important. Among the most visible positive developments are the improvement of the already high degree of computerization and the widespread use of new technology in the payments system, an improved cost structure although operating costs remain high- and an increased international presence and European orientation of banks.

No noteworthy movements were noticed concerning the new Community (and international: Cook ratio) requirements regarding capital adequacy for credit institutions. This factor is expected to be decisive for an ambitious European strategy. A response to the challenge of the post-92 unified Community market may be seen in the increased number of strategic alliances and mergers between banks as well as with insurance companies.

The dramatic growth of collective investment funds (UCITS, Undertakings for collective investment in

transferable securities) has been one of the most significant developments of the French financial markets during the last decade. The regulated rates on demand deposits, high yields combined with a favourable tax treatment and the possibilities offered by the general liberalisation of the financial system are the main factors behind the dramatic growth of these funds in recent years. Large banks manage around 50% of UCITS activity.

**Table 6: Undertakings for collective investment in transferable securities (UCITS) (Net assets at the end of the year; bn FF)**

	1980	1985	1989
SICAV (1)	2.6	449.6	1269.6
(short-term)	(0.0)	(204.0)	(726.0)
FCP (2)	3.9	194.1	433.0*
(short-term)	(0.0)	(90.7)	(131.1)*

(1) Socits d'investissement capital variable  
(2) Fonds communs de placements  
(\*) at 30/6

Source: Banque de France

Recent provisional data point to much higher amounts than those which appear above (for example short-term SICAV exceeded the one trillion FF last March). A measure of the success of these funds is the fact that the French Ucits account for more than half of the total funds invested in all European Ucits put together.

Concerning money markets, noteworthy is the spectacular growth of banks' certificates of deposit since they were first introduced in 1985, but also the sharp rise during 1989 and 1990 of the outstanding amount of companies' commercial paper. Another noticeable fact is the increasing amount of money market instruments held by non-residents: FF 90.9 Mrd in 1989 compared to FF 15.8 Mrd in 1987.

**Table 7: Money market securities: amounts outstanding at end - December 1989 (bn FF)**

	1984	1985	1986	1987	1988	1989
Certificates of deposit	0.0	29.9	64.4	200.5	341.4	515.6
Commercial paper	0.0	3.3	24.0	40.8	63.0	129.1
Treasury bills	311.5	335.6	374.0	434.4	450.0	520.0
Other	28.6	26.3	87.8	45.3	59.1	72.9
TOTAL	340.1	395.1	490.2	721.0	913.5	1237.6

Source: Banque de France

The remarkable success of the Paris futures exchange, MATIF, should be ascribed to the need faced by treasurers and other market participants to cover risks from increased interest rate volatility. Important to this positive development has also been the contribution of a set of prudential and monitoring measures taken by MATIF's regulatory authorities.

**Table 8: MATIF: volume of contracts traded in thousands**

	1986	1987	1988	1989
<b>Interest rate futures</b>				
- French gov. bonds	1.139	11.911	12.357	15.005
- stock index	-	-	40	444
- three month PIBOR	-	-	452	2.296
<b>Currency futures</b>				
- Euro DM	-	-	-	481

*Source: Banque de France*

As the table above shows, the contracts traded in the MATIF are mostly of domestic origin. Nevertheless the introduction, in April '89 of the 3-month Euro-DM contract underlines MATIF's ambition to extend the scope of its activities. More recently - October 1990 MATIF introduced a futures contract based on the yield of long-term bonds denominated in ECUS.

The bond market has also grown rapidly. Although Treasury paper accounts for most of the issues, public enterprises and entities as well as financial institutions are also very active creating thus an important market for non-government bonds characterised by increasing liquidity and internationalisation. Bond market has been a place where important financial innovations and instruments were introduced. Noteworthy in this respect is the issue, for the first time in April 1989, by the French Treasury of an ECU-denominated bond issue (OAT). Total gross issues of these bonds reached 6085 million ECUS by end of January 1991.

### 5.3 Financial policies of the corporate and household sectors

The flow of funds data reveals a number of important changes in the financial structure of the main sectors of the economy. The net improvement of the financial position of the corporate sector was one of the most interesting changes. Since 1983 there was a clear tendency on the part of enterprises to reduce their debt burden and make wider use of internally generated savings. This policy was made possible by the improved companies' profitability since 1983 and the resulting increased liquidity.

**Table 9: Enterprise sector: self-financing ratio (\*) (Excluding large nationalised corporations; in %)**

1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
66.3	60.3	64.2	71.2	76.0	75.3	98.1	90.2	95.2	88.1

(\*) Ratio of gross savings over gross fixed capital formation

*Source: National accounts*

The basic reason for the high degree of indebtedness of the corporate sector dates back to the period of low interest rates and easy access to banking finance. The sharp rise of world interest rates during the first half of the '80s which were largely reflected in domestic rates, increased substantially companies' financial charges rendering necessary an operation of financial consolidation.

In parallel to the reduction of indebtedness to banks, and taking advantage of the opportunities offered by the financial liberalization, the enterprises turned in an increasing degree to the capital market. The rising share prices made profitable the raising of equity capital.

**Table 10: Non-financial enterprises: equity capital raised on capital markets (bn FF)**

1980	1982	1984	1986	1988	1989
52	43	73	177	168	229

*Source: Eurostat, Financial accounts: France*

An interesting phenomenon regarding the financial behaviour of enterprises is the rising share of securities in their holdings of financial assets. These securities include both short-term debt instruments but mainly shares and other equities. The holding of short-term bills indicate an active cash management policy made possible by the creation of the money market and the availability of a wide range of instruments.

The sizeable amounts of shares in companies financial assets (normally equities appear on the liabilities side of companies' balance sheets reflecting the raising of equity capital, see table above) may be ascribed to companies' interest in acquiring stakes in other firms as part of their strategy to strengthen their position in view of the realisation of the single European market. This phenomenon may also partly reflect the rising direct investment abroad made by French companies in recent years.

The financial behaviour of the Households sector is characterised by a fall, since 1981, of its savings rate as percent of GDP and also by a more sharp fall, with certain hysteresis (since 1984) of the sector's rate of financial savings.

A falling savings rate during the '80s was an almost universal phenomenon despite the sharp rise of real interest rates. The more pronounced drop in the financial savings rate since 1984 in France may indicate that financial saving served as a shock absorber enabling households to keep their previous consumption pattern despite a lower growth rate of their income. Both rates showed an upward trend since 1988 but remain below their previous levels.

Recent initiatives aimed to favour long-term savings such as the PEP (popular savings plan) managed to mobilize considerable amounts and contributed to the reversal since 1988 of the falling financial saving trend.

**Table 11: Saving indicators: Households sector**

	1982	1983	1984	1985	1986	1987	1988	1989	1990
1. Savings rate as % of dis. inc.	17.3	15.9	14.5	14.0	13.2	11.5	12.4	12.3	13.1
2. Financial savings rate % of dis. inc.	6.3	5.5	4.9	4.5	4.1	2.8	2.8	2.9	3.4
3. Compensation of employees % of GDP	56.6	56.3	55.5	54.8	53.4	52.7	51.9	:	:
4. Private consumption (1980 prices, % change)	3.5	1.0	1.0	2.4	4.0	2.7	3.1	3.3	:

Source: National accounts

The investment behaviour of households was affected considerably by the financial liberalization and the creation of new markets and instruments. Between 1980 and 1989 households holdings of securities (shares and bonds) more than doubled reaching 48% of their total assets up from 23.7% in 1980 whereas placements in deposits fell to 37% from 60% in 1980%.

**Table 12: Structure of financial assets: Households sector**

	1980	%	1989	%
1. Cash and deposits	1755	60.1	3530	37.3
2. Bonds and shares	691	23.7	4546	48.0
3. Life insurance and pension funds	95	3.3	684	7.2
4. Other	377	12.9	710	7.5
5. TOTAL ASSETS	2918	100.0	9470	100.0

Source: OECD, Financial accounts

Noticeable also is the development of funds invested in life insurance and pension funds. Their share more than doubled during this period from 3.2% to 7.2%.

## 5.4 External dimension of financial liberalization

### 5.4.1 Financial integration and capital movements

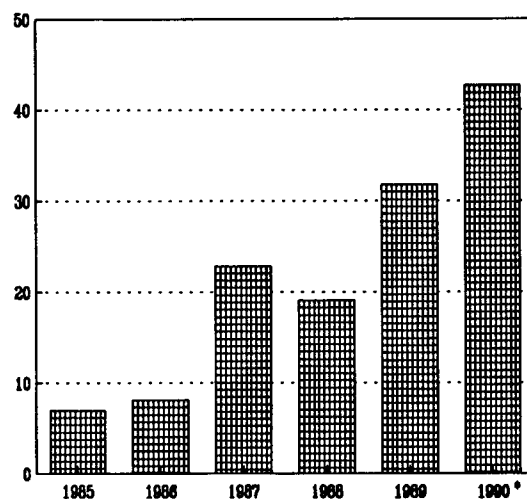
The elimination of the last restrictions on the movement of capital on 1st January 1990 -six months ahead of the deadline set by the Community capital movements directive- was the final step of the liberalization process of the external financial transactions which had started a few years earlier.

The external financial liberalization following that of the domestic financial markets made possible a more international orientation and integration of the economy. A measure of the development of France's international financial integration is given by the ratio of the capital flows over the flows of goods and services.

This macroeconomic indicator of financial openness represents the synthesis of a sharp rise of capital movements in both directions, inflow and outflow, motivated by a number of reasons linked to the nature of the capital flow.

The phenomenon of the considerable rise of gross capital flows with a parallel quasi-equilibrium in the current account underlines the autonomous character of these capital movements and the dissociation of the developments in the current and capital accounts of the balance of payments following the financial liberalization and free capital mobility (a phenomenon also observed in other countries).

**Graph 33: Degree of international financial integration (1)**



\* 1st quarter

(1) Ratio of gross capital flows over the flows of goods and services

Source: Banque de France

Flows of direct and portfolio investment that took place in recent years are provided in the table below:

<b>Table 13: Direct and portfolio investment flows bn ECUs</b>						
	1. Direct investment			2. Portfolio investment		
	1987	1988	1989	1987	1988	1989
Inflow	4	6.1	8	7.6	9.9	27.1
Outflow	-7.5	-10.8	-15.3	-2.3	-3.5	-5.5
Net	-3.5	-4.7	-7.3	5.3	6.4	21.6

*Source: Eurostat*

The considerable growth of direct investment capital was probably motivated by industrial strategy considerations in view of the completion of the unified European market (the Single market effect). Different was the motivation behind the sizeable net inflow of portfolio investment capital: it was mainly attracted by the high interest rates of franc denominated assets, basically bonds and Treasury bills, combined with markets' confidence in the stability of the franc.

Concerning direct investment capital it is noticeable the important share of the banking sector in both inflows and outflows. Direct investment abroad by French firms was nevertheless three times as high than inflows in 1988.

<b>Table 14: Direct investment in banking mio ECUs</b>								
Inflow				Outflow				
1985	1986	1987	1988	1985	1986	1987	1988	
499	777	877	1031	837	1190	1952	3057	

*Source: Eurostat*

Regarding short-term capital flows such as bank deposits, recent indications point to a considerable growth during the first half of 1990. These funds concern both outflows and inflows and their motivation seems to lie in banks' effort to circumvent the burden of reserve requirements applied to deposits in France. Following those developments the Banque de France reduced considerably the rates of reserve requirements on banks' liquid liabilities.

#### 5.4.2 The financial sector and the unified European market

The good overall performance and quick adjustment of the French financial sector under competitive conditions following the financial liberalization gives a measure of

its considerable potential for an active presence at the European and international level.

The macroeconomic policies and performance since 1983 and the commitment to a policy of monetary stability provided the background for the successful passing to an open and market-centered financial system. These elements constitute also the indispensable framework of stability for the development of an international marketplace.

The size of the economy and, especially, the important amount of savings it generates are also positive factors which enhance the long-term potential of an international financial centre.

French banks' comparative strength in the international markets lies in their long tradition of important international presence -they dispose one of the largest number of branches and offices abroad- and their active participation in the restructuring of the European financial environment in view of the Single market (see above data on foreign direct investment of banks).

Existing indications point to the fact that the major French banks have reached, or are close to, the solvency ratio required by Community directives and international bodies (Basle Accord). Nevertheless an active presence in the European, and more so, in the international scene require, among others, a strong capital base. This is particularly true for corporate finance and investment banking, activities which are considered as the most promising in the unified European market. Therefore the need to raise new equity capital appears certain for those banks having major international ambitions. The case of state-owned or controlled banks seems to pose more difficulties given the narrow margin for capital injection from the state budget.

Domestically French banks dispose an extensive branch network. This provides a solid basis and renders rather safe their position as far as retail banking is concerned: the high fixed costs required for the creation (or acquisition) of a branch network by foreigners makes such a "risk" less probable.

As relatively weak points, compared to the most efficient competitors, of French banks can be cited the high operating costs -despite the progress achieved during recent years- high intermediation costs and rather low profitability. The already mentioned free provision of payment services to customers, as a counterpart to non-remunerated demand deposits, leads to phenomena of cross-subsidisation of non-profitable by profitable bank services and contributes to the lack of transparency regarding the cost structure of the banking services and to high costs of financial intermediation.

The existence of regulated and tax-exempt liquid savings (which accounts for one third of total deposits), and correspondingly subsidised credits to high priority sectors through specialised credit institutions, are the most important remaining restrictions in the credit system. This is an area where reform seems necessary both for



reasons of transparency and efficiency as well as for reasons of compatibility with Community rules after '92.

Paris position as a financial centre was strengthened by the remarkable performance of its futures and options market: MATIF's interest rate futures market ranks third worldwide. Moreover activity of collective investment funds, which exceeds the corresponding ones of UK, Germany, Italy and Benelux put together, gives also a measure of the market's ability to mobilise savings.

The significance of the above positive developments is justified by the importance of the "size" factor for the establishment of an international marketplace. This has to do with the attainment of the necessary "critical mass", a concept synthesising elements of market depth and liquidity, economies of scale and scope and an environment favouring synergy and financial culture.

Heavy investment in infrastructure, modern technology and an efficient regulatory and settlements system are the strong points of the Paris stock exchange. Noteworthy is also the growth of the money market which managed to attract considerable amounts of foreign funds.

The taxation of financial savings and that of financial services business are important factors for the financial activity and merits consideration. In France the average tax rates on income from savings was, until recently, veru high and the risk of delocalization of savings, following the compleme remove of restrictions on capital movements, was real. The substantial reduction during 1990 of the rates on the income from bonds and deposits plus the rather high tax-exempt level for savings' income has reduced considerably such a risk. Nevertheless to the extent that no agreement for a minimum community-wide, tax rate on savings is reached such a risk, though reduced, would remain. This refers mainly to the sophisticated investor and less to the small or average one. It is noted in this respect that the degree of concentration of financial wealth is high (not only in France) : it is estimated that, in France, around 35% of total financial wealth is held by 1% of investors.

Concerning taxation of financial services, a positive development was the abolition of the 5.5% tax on life insurance premiums (July 1990) and also the fixed commission for stock exchange transactions (July 1989). On the other hand the tax on stock exchange transactions remains unchanged.

## 6. The tax system and the internal market

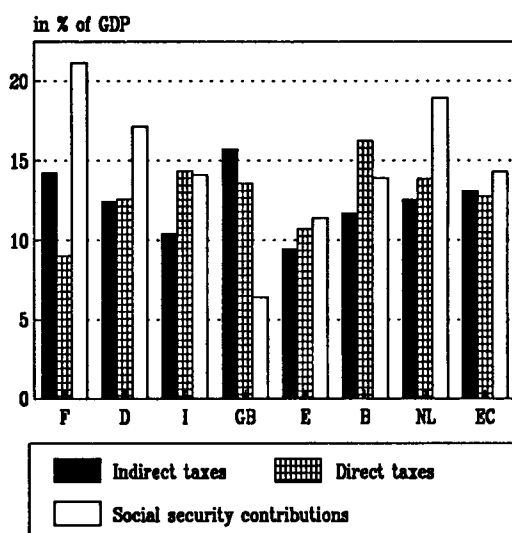
### 6.1 Introduction

As the process of European integration continues towards EMU the issue of taxation will increasingly come into focus. From a macro-economic point of view the share of public expenditures financed by explicit taxes is important for the stability of the monetary union as both monetary financing and excessive accumulation of public debt must be ruled out. On the microeconomic level tax incentives are important for at least two reasons. Firstly, mobile production factors will be responsive to different tax treatment. Secondly, because EMU will alleviate the external constraint, tax rules that affect investment and saving decisions may have pronounced and persistent effects on the current account balance. This in turn may exercise some pressure to harmonise tax incentives.

### 6.2 The tax structure in France - an examination at aggregate level

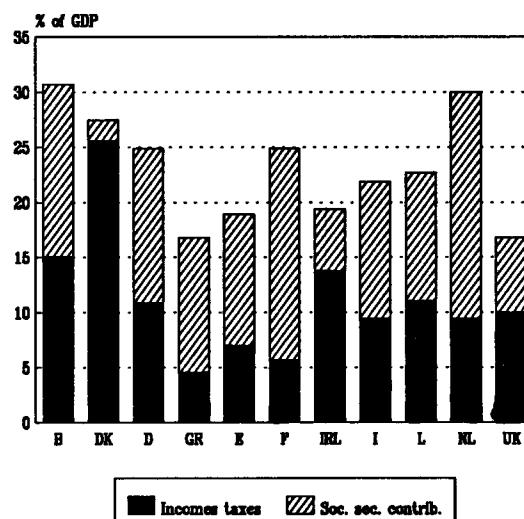
The salient features of the tax structure in France are relative low direct taxes (9% of GDP against 12 1/2% of GDP for EUR12) and relatively high social security

Graph 34: Tax structure  
1989



Source: National accounts

Graph 35: Income taxes and social security contributions  
in member states, 1987



Source: OECD Revenue Statistics, 1989

contributions : indeed the highest in the Community (21 1/2 % of GDP against 14 1/2% of GDP for EUR12).

An important part of the social security contributions are paid by the employers. At face, therefore, the French enterprises would for this reason seem to be excessively burdened and disadvantaged in the steadily increasing European competition.

Social security contributions, however, cannot be counted as a tax burden for the enterprises even though they are initially paid by the employers : all taxes on compensation of employees will eventually have to be borne by the wage and salary earners. The reason is that compensation is determined by the contribution of labour to value added, which again is dependent on the quality of labour, the production technique and market conditions. The consequence is that if higher social security contributions are imposed on employers, wages and salaries will have to be reduced so that total compensation remains unchanged.<sup>1</sup>

From the point of view of employees the overall tax burden is important i.e. the sum of incomes taxes and social security contributions - whether paid by the employees or the employers. Graph 35 shows that this sum of taxes on labour incomes (in terms of GDP) is lower than in many other high-income Community countries and is at the same level as in Germany. At the aggregated level, therefore, there should be no strong incentives for labour to migrate (the micro-incentives are discussed later).

<sup>1</sup> If wage and salary earners are not willing to reduce their wage claims accordingly, competitiveness will be eroded by too high unit labour costs, jobs will be lost and a higher rate of unemployment will exercise the necessary downward pressure on wages.

The logic of the internal market suggests that taxes be imposed with an eye to the mobility of the tax sources. Capital (except for property) and goods are the most mobile sources. Therefore, fiscal authorities should be more strongly concerned with tax incentives in relation to capital and goods. At the aggregate level indirect taxes are only slightly higher in France than the average of the Community. However, compared with bordering countries, indirect taxes are somewhat higher suggesting that indirect taxes can hardly be increased.

All in all, at the aggregate level the taxes and the tax structure in France does not seem much out of line with the requirements of further European integration. At the micro level, however, some adjustment may be warranted.

### 6.3 Charges on household income

#### 6.3.1 Social security contributions

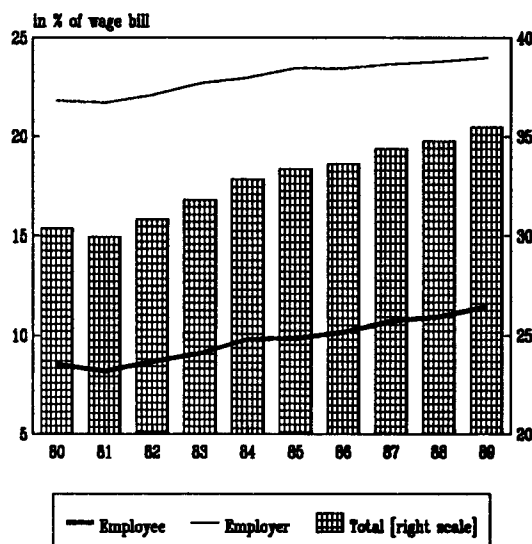
The way of financing the social security system, mainly the retirement branch, will be a major problem in the next years. The age structure of the French population at the beginning of the next century will affect downward the amount of social contributions, while the social allowances will increase.

Graph 36 shows an implicit rate of social security contribution between 21% and 24% of gross wages and salaries for employers over the period studied and one of between 7% and 11% for employees: this reveals a very sharp acceleration in the proportion of employee contributions (an increase of 6 points between 1970 and 1989). Until 1983, the nominal rates of employer and employee contributions were raised regularly. Since then, only employee rates are rising.

In order to reduce the labour costs of the low wage earners, and therefore to increase employment, French authorities try to reduce the social contributions paid by the employers for these workers. The rigidity of SMIC should be softened by this way.

Social security contributions can be considered as a withholding tax on salary income. This tax is degressive as a system of ceilings is applied on certain contributions: social security contributions are payable only on a proportion of the wage which is below the ceiling. This system is being phased out and remains only for old age pension contributions because of a complicated system of complementary retirement pensions. The need for a change in the structure of the financial sources of the Social Security has led to the "generalized social contribution" system (*contribution sociale généralisée*) which, based on total household incomes, increases the basis of resources of Social Security. It might represent the first step towards a reform of the system of taxation. It aims to ensure that the social security system is no longer financed exclusively by contributions (from employees and employers) calculated on salaries, but also by charging other incomes (retirement pensions and un-

Graph 36: Social security contribution



Source: INSEE

employment benefits if their recipients are subject to personal income tax) and on investment income. The "generalized social contribution" also aims to correct the inegalitarian effects of making the old age pension contribution subject to a ceiling which penalizes wages beneath that ceiling (FF 11 040 per month).

This new contribution (levied at a rate of 1.1%) will not increase revenue but alters the structure of social security financing. It should raise some FF 37 billion in 1991, which still represents a small proportion of all contributions collected by the general social security system (under 5% of the contributions collected in 1989). The yield from the "generalized social contribution" will make it possible to reduce employee old-age pension contributions rates by 1.1 percentage points.

#### 6.3.2 Direct taxation

Direct taxation of household income was only somewhat more than 4% of GDP in 1990. It is an annual tax charged on the total net income of individual entities. The progressive tax structure takes account of the dependants in the household (e.g. number of children) and applies to all the various types of income net of deductions, allowances and charges. Income tax revenues grew sharply between 1960 and 1985 but recently slowed down markedly as a result of the series of reliefs introduced in 1985, which brought the top rate of tax down from 65% to 56.8% and extended the system of graduated relief. The effect has been to take some two million people out of tax altogether, and to reduce the amount of tax paid for a further two million.

In comparison with the other European countries, income tax is of limited importance within the French tax system. This can be explained, first, by the low rates

charged in the first income brackets (the lowest rate is 5% compared with 25% in the United Kingdom) and second by the narrowness of the tax base. Taking into account allowances and various deductions, the low rates charged in the first income brackets, the system of graduated and the exemption from paying small amounts of tax, the tax base is so narrow that many taxpayers do not reach the minimum taxation threshold.

In 1986, 1% of households declaring the highest incomes paid 27% of tax and 10% of households paid 64% of tax. The tax rules in force therefore favour low and middle-income taxpayers. However, these conclusions would be qualified if the amount of social security contributions paid to general government was added to income tax.

Taking charges and contributions based on the wage bill<sup>1</sup>, France would be at the bottom of the scale if direct taxes alone were considered. The consideration of all contributions places France among the countries which tax wages and salaries at more than 50%. The United Kingdom is the country where taxation is by far the lowest (some 30%) (see Graph 37).

Graph 37: Taxes on salaries received by households 1989



Source: National accounts

### 6.3.3 Taxation of saving

When savings are differently taxed, distortions may take place between investors (residents-non residents, low income-high income investors), borrowers (saving banks, banks, enterprises), assets (short term, long term, bonds, shares), and consequently financial markets. Therefore, the return before tax must be different in order to take into account the differences in taxation. In France, a great step towards a very strong reduction of the distortion between assets was taken with the Law of Finance of 1989. These measures mainly aimed to equalize taxation on bond and share incomes and to reduce the tax burden on financial savings in order to avoid the danger of their dislocation towards more tax favourable financial centers. Nevertheless, the taxation of saving is still fairly complex, given the many measures which aim to promote one or other investment and in theory to favour the smallest incomes.

One typical feature of the French taxation is that very safe and liquid assets (the saving books) are tax-exempted. These non taxed savings are collected only by the saving banks (Caisse d'épargne et Crédit Mutuel) resulting in a segmentation of financial markets. Moreover administered interest rates applied to these assets. Banks have been excluded until the introduction of new financial assets as the Compte de Développement Industriel and recently, the Plan d'Épargne Populaire.

The financial resources collected under this favourable tax scheme are assigned to specific uses (social housing policy) and by-pass the money market. This deflection of funds is especially significant because the banks may not pay interest on their sight deposits to attract savings. Nevertheless, the above-mentioned tax measures (reduction of the rate of the levy in full discharge of personal income tax on bond income, reduction of the tax rate on capital gains, permission to mutual funds (SICAV) to capitalize their interest income) together with some allowances have strongly reduced the differential between the taxation of savings books and that of marketable assets. Nevertheless, there are still certain differences but they are now not very important. Therefore the increase of credit costs which was important in the past, is no longer significant.

Recently, taking into account the difference between the regulated interest rate on saving books (4.5% net of taxes in 1990), and the market yield of competing financial assets, mainly the short-term mutual funds (SICAV de trésorerie), savers seem to gradually reduce their investment in saving books.

The taxable income produced by short-term investments is subject to a levy which is in full discharge of income

1 In calculating the burden of taxation on household income not only wages, but also other taxable incomes should be taken into consideration: retirement pensions, incomes earned by the self-employed, property income and income from financial assets. Consequently, the ratios in Graph 37 are biased upwards. Even so, the results remain valid, since wage represent by far the major share of household income

tax. For investments involving financial intermediation (e.g. cash vouchers), this levy limits the taxation of interest received to between 38.1% and 48.1% (53.1% if the recipient does not state his name).

On the other hand, a levy of 18.1% applies to income from market instruments, certificates of deposit, commercial paper, etc. received by private individuals. This tax rate applies also to income from bonds.

Taxation in respect of shares aims either to limit the amount of corporation tax which affects the dividends paid to shareholders, through the tax credit system.

The tax credit, introduced in 1985, reduces the double taxation of profits distributed by a resident enterprise, once under the heading of corporation tax, and once under the heading of income tax. Corporation tax, which is charged at 42% on the taxable profit to be distributed, is reduced to the rate of 13% (by means of a 50% credit), to which the shareholder's income tax has to be added. The shareholder who receives a dividend becomes a creditor of the Treasury in respect of half the profits tax paid by the company. The capital gains, which represent the main expected profit of the shareholder, are taxed at the same rate than the interest income on bonds and other marketable assets (18.1%).

Nevertheless, dividends are still more taxed than interest income on marketable assets. This could partly explain the small size of the French equity capital market. This is despite the political determination, announced since 1978, to encourage the expansion of the share market. The Monory Law, introduced in 1978, exempted savings invested in French shares from income tax with an upper limit being set for this exemption. The Monory Law was succeeded by the equity savings plan (*compte d'épargne en actions*), which was in force from 1983 to 1988. The 1987 law on savings introduced the retirement savings plan (*Plan d'épargne retraite: P.E.R.*) which has been in force since January 1988.

In 1990, the retirement savings plan (P.E.R.) was replaced by a quite new product, the Popular Savings Plan (*Plan d'Épargne Populaire: P.E.P.*) which in principle creates a fiscal advantage in favour of long-term investment.

Savers enter into a popular savings plan, for a minimum period of 8 years: these are run by credit institutions, investment houses and insurance companies. Interest incomes is exempt from tax in respect of an amount invested which does not exceed FF 600 000 per person: this is twice the upper limit for the housing saving schemes (*Plan d'épargne-logement*) which had previously been the most advantageous product in this respect. In addition, persons who are not taxable are offered a bonus equal to 25% of annual payments up to a limit of FF 1 500 a year for 10 years. This new product not only helps to break down the barriers in the financial system as regards the collection of funds on favourable tax terms; except for the industrial development account (*CODEVI*), this had been the prerogative only of the savings banks and the *Crédit Mutuel*. It also introduces for the first time, the principle that the issuers are free to fix the remuneration, with a view to deregulating credit conditions. Interest rates determined in this way are guaranteed either for the first year, or for the whole life of the plan.

The popular savings plan (P.E.P.) should permit banks to collect a steady stream of resources and to counteract the tendency for banking disintermediation to increase as a result of the success of undertaking for mutual funds as a whole (*Organismes de placement collectif en valeurs mobilières: O.P.C.V.M.*) and particularly for *S.I.C.A.V.* (*Société d'investissement de capital variable*).

Nevertheless, if funds are withdrawn early from the plan, the levy, in full discharge of income tax is applied at the rate of 38.1% if the capital was invested for under 4 years and at 18.1% if it was held for a longer period. These tax penalties mean that the yield and liquidity of the plan resemble those of the "A" savings book.

## 6.4 Company taxation

Corporation tax was introduced in December 1948 at the rate of 24%, was increased to 50% in 1959, and subsequently remained unchanged for over 25 years. Since 1986, this rate has been discretely brought down and in 1991 it stands at 34% for reinvested profits and 42% for distributed profits. The tax is charged on all profits or income earned by companies and other legal persons referred to in Article 206 of the General Tax code.

In order to limit double taxation, a 50% tax credit is available for distributed dividends. Depreciation and interest payments are deductible from the taxable profit. Under ordinary law, straight-line depreciation is allowed but firms may opt for the practice recognized by the tax authorities, which also allows degressive depreciation for certain goods (in the main new investment goods); the coefficients for this method depend on the period of utilization. For certain types of investment (research, anti-pollution), the law allows exceptional depreciation. 100% depreciation applies to software and energy-saving investment in the first year.

**Table 15: Total stock market capitalization as a proportion of gross national product**

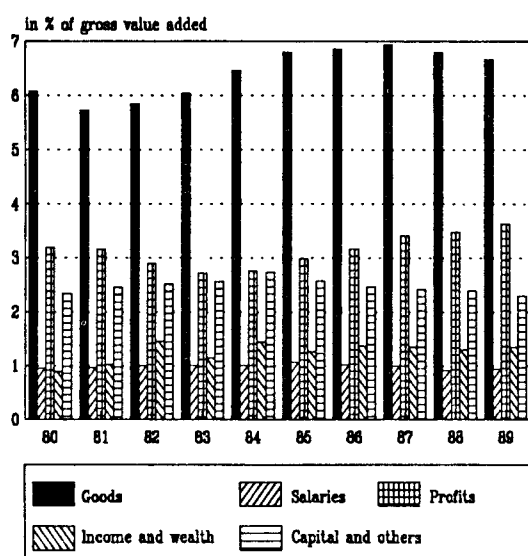
	1988	1989
United Kingdom	98.1%	75.8%
Netherlands	41.3%	54.5%
Belgium	39.4%	44.3%
Germany	20.2%	27.3%
Italy	16.3%	18.1%
France	23.5%	32.7%

*Source: Federation of Stock Exchanges in the EC*

It would be insufficient to take the corporate tax as the sole criterion for evaluating the burden of taxation on companies. Not only does this charge represent a fairly small proportion of the total fiscal resources of the public authorities, but it does not represent the principal tax paid by companies. Graph 38 shows the respective proportions (as a percentage of gross value added) of all taxes payable by companies. The taxation of products used in the operating cycle (the domestic duty on petroleum products is part of this) represents some 7% of value added, but the proportion has been falling since 1988, after having risen steadily since 1982. The tax on profits represents under 4% of value added, but its share has grown since 1985 following the appreciable improvement in company results. The other taxes are stationary or in decline, as is the case for the various taxes linked to production, which include the business tax (levied by local authorities) which is charged on fixed assets used for the business activity.

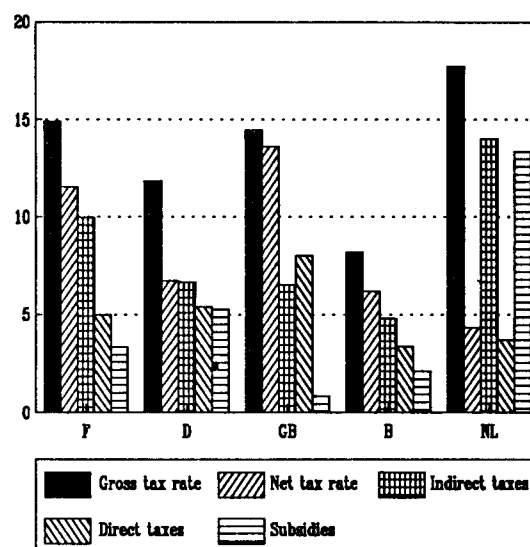
Analysis of the relative incidence of direct and indirect taxation as a proportion of total fiscal charges payable by companies shows the priority given in France to indirect taxation, which represents over 60% of the total. The relative share is similar in the Netherlands, while in the other countries there is more balance between the two types of taxation. The following Graph 39 shows the total fiscal pressure, gross or net (i.e. after deducting subsidies and aid for investment) and its main components, in relation to value added. The United Kingdom and Belgium are the countries which redistribute the smallest part of taxes to firms in the form of subsidies or aid for investment, while France is an intermediate position.

Graph 38: Tax structure of enterprises



Source: INSEE

Graph 39: Tax burden on gross value added of enterprises, 1989



Source: National accounts

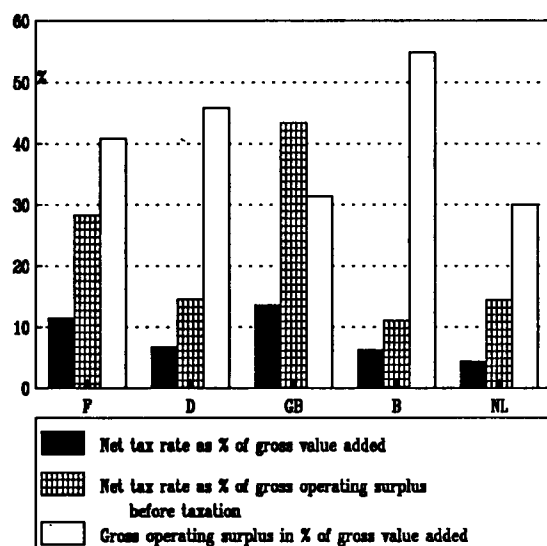
All in all, among the countries under examination, France is the country with the highest gross rate of fiscal charges after the Netherlands. In net terms, only the United Kingdom is ahead of France. These results must be analyzed with caution as international comparisons in the fiscal area being affected by unharmonized statistical sources. Nevertheless, they show the main characteristics of the different fiscal systems.

The analysis carried out so far would be incomplete if it did not include a reference to the factors which determine a component of total tax burden: corporate tax. Its amount is in fact affected by the level of profits, expressed by the profit margin before taxation and subsidies, and by the implicit rate of taxation on the profits.

The net fiscal pressure (the net tax payments divided by gross value added) has to be assessed in relation to the level of profits of enterprises (the gross operating surplus before taxes divided by gross value added). The gross operating surplus has been chosen as a proxy for the tax base of corporate tax in the different countries, in order to show that the tax burden can be partly explained by different levels of profitability. The other determinant will be the value of the implicit tax rate, which is affected by the national tax systems.

Graph 40 shows that in Germany, Belgium and the Netherlands even though profitability is far higher than in France, the burden on the value added of enterprises is smaller because the operating surplus is more favourably taxed. The opposite is the case in the United Kingdom with France in a similar position.

**Graph 40: Determinants of the net tax burden on enterprises, 1989**



Source: National accounts

## 6.5 Final remarks

France has experienced strong improvements in its public finance accounts towards the absorption of central government deficits. Nevertheless, the financing problems of the social security system particularly of its pension branch have not yet been solved. New resources with also a change in the financing structure might become necessary.

The tax burden of the French economy is one of the highest in the European Community (the highest among the five big European countries) and therefore affects the economic activity first by the amount of resources drawn on from national wealth and secondly by the distortions created in the allocation of resources.

The amount of social contributions is larger than in other European Community countries due to the size of social transfers (mainly retirements which represent more than

50% of total social allowance in 1989) and its financing (based on wage bill).

Therefore, the weight of social contributions on the wage bill was of about 35% on 1989 (of which about 25% are employers contributors) and could affect the amount of savings available in the economy. Moreover, the low wage earners are penalised because they pay more contributions in relative terms because of a ceiling system applied to pension contributions.

The interest income of a large part of liquid financial assets is totally exempt of tax. Compared to the taxation of other assets this has distorted the saving behaviour in favour of saving books. Moreover, these revenues have not increased the resources available for private investment because this liquid saving is allocated to specific uses (social housing policy). Therefore, the specific financing needs of corporate sector are not satisfied.

The nominal fixed exchange rate commitment and the next steps towards the European monetary union, including the internal market in 1993, will increase the price competitiveness between European enterprises. Therefore, changes in taxation can no longer easily be shifted onto prices in order to keep the previous profitability after taxes. With capital mobility inside the internal market, this will imply that more taxed enterprises have to reach a higher profitability before taxes than the less taxed foreign competitors in order to have the same rate of return after taxes. This result can be reached by lower unit labour costs as a result of either stronger productivity or a lower nominal wage bill. Therefore, the adjustment to different tax burdens at the international level will demand either an improved allocation of capital or a bigger flexibility of wages including the level of social contributions.

On the other hand, the full deductibility of interest payments reduces the real burden of indebtedness, and therefore the cost of capital boosting investment. The monetary integration does not allow any longer lower real interest rates in France than in the other member countries. Therefore, only the tax system will be able to influence the financing costs. Nevertheless, the deductibility of interest payments being commonly applied almost everywhere else, this does not increase the real rate of return of French enterprises relative to its partner countries.

## 7. Monetary instruments and intermediate targets

### 7.1 The reform of monetary aggregates

#### 7.1.1 Modification of the Content of the Aggregates

Faced with the rapid development of financial innovation, the Banque de France introduced, as of the beginning of this year, a reform of monetary aggregates. The reform essentially concerns the OPCVM (undertakings for collective investment in transferable securities), whose rapid development made it necessary to establish a more detailed statistical treatment and a more meaningful monetary classification in order to avoid upsetting the development of monetary aggregates and the conduct of monetary policy.

The principle previously followed in the classification of the OPCVM in the monetary statistics was the one of transparency. According to that principle the monetary assets included in the portfolio of all OPCVM were broken down and distributed among the M variables; they were assumed to be held directly and totally by non-financial residents. This treatment was proving less and less appropriate as :

- financial institutions are holding increasing amounts of OPCVM units;
- non-residents are bound to increase their holdings in the framework of the open European financial markets;
- portfolio switches by the OPCVM, into or out of certain categories of assets (for example a movement out of CD's, included in M3, into TB's) could upset the development of monetary aggregates even though the attitude of OPCVM holders did not change.

The need for the protection of savers has recently led to the establishment of a fairly detailed classification of OPCVM by management objective so that the ones who have a predominantly monetary character can be singled out. The ones classified as short-term seem to have indeed such a monetary character as their capital risk is low and they are easily transformable into means of payment. Detailed statistics on the holders of parts of OPCVM are currently being elaborated in the framework of a new accounting framework for OPCVM. At present, are however available fairly reliable estimates of parts held by non-financial residents.

According to the new methodology M2 no longer includes assets held by OPCVM. Conversely, M3-M2 now includes those parts of short-term OPCVM held by non-financial residents. A new aggregate, M4, replaced the previously monitored L. The new M4-M3 includes Treasury bills and commercial paper held by non-financial residents, i.e. assets with a high degree of proximity to M3-M2 items.

The development and innovation of financial markets and the increased possibilities of switching between monetary and financial assets makes it necessary to

monitor also a number of indicators representing various categories of non-monetary savings of non-financial agents. Classified by order to closeness to monetary assets, those are :

- aggregate P1, incorporating assets that are stable and non-negotiable (home and popular savings plans as well as capital accumulation certificates);
- aggregate P2, including bond open-ended unit trusts (SICAVs), other bonds and insurance companies technical reserves;
- aggregate P3, consisting of share SICAVs and other shares.

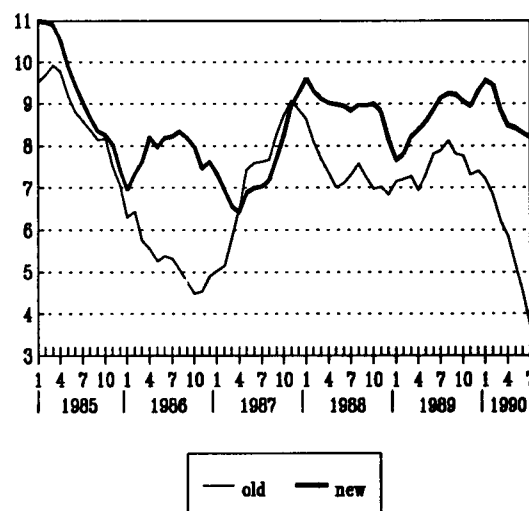
Two further improvements were brought about in the monetary/financial indicators. Firstly, a table for Total Domestic Indebtedness of non-financial agents was established (replacing the previously used Total Domestic Credit). This gives a comprehensive view of the structure and trends in financing circuits on a quarterly basis and serves to explain the link between changes in domestic indebtedness and in monetary aggregates. Secondly, a Quarterly Table of Financial Operations, compatible with the existing annual tables, was elaborated and allows the application of national accounting methods to the analysis of macro-financial trends.

#### 7.1.2 The Performance of the New Aggregate

The new statistical treatment mainly affects the profile of M3. It appears from the following graph that the new M3 grows in a significantly more stable manner than the old one.

The new M3 obviously avoids the very large swings of the old aggregate that occurred in 1986-87 and in 1990.

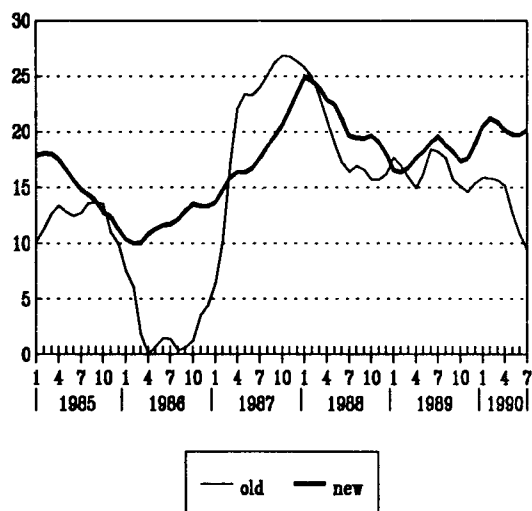
Graph 41: Twelve-month change in M3\*



\* 3-month moving average  
Source: Banque de France



Graph 42: Twelve-month change in M3-M2\*



\* 3-month moving average  
Source: Banque de France

A clear picture of the difference in the development of the new aggregate is obtained by plotting the content of M3-M2.

In 1985, the old M3-M2 failed to display the portfolio switch away from short-term OPCVM causing a slow-down in the growth of the new aggregate. On the contrary, it was speeding up under the influence of the upsurge of monetary assets of total OPCVM (including bond and share undertakings). As of the second quarter of 1986, a persistent tendency towards higher interest rates and the then prevailing expectations caused a considerable swing from long to short term investment and, under the additional influence of institutional changes, from intermediated investment to short term market products. This movement is shown by the new M3-M2 but the old aggregate failed to indicate it. On the other hand, its growth in the following year overshot the one of the new aggregate. As the weight of short-term OPCVM in the total increased and the weight of money market assets in their portfolio developed substantially, the old and the new M3-M2 followed similar paths in 1988 and 1989.

Since the end of 1989, portfolio changes and dislocation of assets caused a much more rapid deceleration of the old aggregates whereas the new one, less sensitive to both, remained relatively stable. Indeed, the OPCVM are now considered as financial intermediaries; by consequence, it is now their liability side which is significant for the determination of financial behaviour. This could, however, contradict the definition of the aggregate: if a short-term OPCVM switches from CDs to TBs, M3 is not affected, whereas it is if the same operation is made by a non-financial agent. Indeed, this raises the more general question of whether the greater stability of

growth, that the new aggregate displays, is in fact an advantage or if, on the contrary, it could not lead to the loss of a certain amount of information.

### 7.1.3 M3: the new target variable

Until the end of 1990 the intermediate target variable in France was M2, since it included transactions holdings which can be immediately or very rapidly used in the markets of goods and services, thus affecting demand. However, at present interest rates are high, while regulations prevent remuneration of sight deposits and the remunerated deposits included in that aggregate are subject to limits. In such a situation, the deposits included in M2 tended to grow less rapidly than would seem appropriate on the basis of the growth of the final target variables. Thus the M2 was no longer judged appropriate as a target variable for monetary policy.

As of 1991, monetary policy targets M3 which includes money market assets remunerated at market rates and thus avoids the consequences of those switches in portfolio. The new aggregate was found, by the French authorities, to be sturdier than the old M3. For example, the old M3 grew by only 3% in 1990 while the new one rose by 7.2% which seems to correspond better to the state of liquidity in France and also has more continuity with the 8.9% growth registered in 1989.

Other reasons also contributed to that choice. Firstly, the above mentioned stability of the new M3, since the new treatment of short-term OPCVM safeguards it against a certain number of deviations and distortions. Secondly, using an M3 target brings French practice more into line with that of its major narrow band ERM partners. This makes it easier both to examine and to coordinate monetary policies in the European Community.

Two further characteristics of the new monetary target variable are worth mentioning. Firstly, the French M3 is broadly defined. Compared to GDP it has a coverage of about 75% whereas Germany's classic aggregate M3 covers roughly 50 to 55%. Secondly, the new M3 grows faster not only than the old one but also than nominal GDP. Compared to the latter, in particular, it grew about 1.5% faster, during the past three years, indeed with remarkable consistency. It is on that basis that the 1991 target was arrived at: nominal GDP was, at that time, forecast to grow by 5.4% so an interval was chosen for M3 of between 5 and 7%.

### 7.1.4 Towards a European Monetary Aggregate

Experts from European central banks are currently working on the harmonization of broad money aggregates used in the Community, in relationship with the Economic Unit on behalf of the Committee of Governors in Basle. The aim is to examine the scope for improving the harmonization of national definitions, as more consistent aggregates would facilitate the assessment of the compatibility of national monetary policies, and assist in the future development of a Community-wide aggregate.

gate. Statistical harmonization will, however, be limited by the need to preserve the link between national monetary aggregates and the final goals of monetary policy. This link may differ according to the specific structure of a country's financial sector.

Starting with the existing national definitions a main criterium for the harmonization is the degree of maturity of assets. The main problems are : (i) the treatment of time deposits, non-negotiable certificates, and repurchase agreements; (ii) the implications of rapidly increasing cross-border holdings and foreign currency assets; (iii) the fixing of the boundaries between the issuing and holding sectors.

As mentioned earlier, the adoption of M3 as the intermediate target variable in France is placed in the framework of this European effort. The new, larger, monetary target variable is more appropriate in view of the the effort for coordination and harmonization but further steps are necessary.

## 7.2 Monetary instruments: the case of minimum reserve requirements

### 7.2.1 Introduction

The historical purpose of minimum reserve requirements was prudential, i.e. to adequately ensure bank liquidity in order to safeguard deposits, thus contributing to a greater stability of the financial system. The close supervision of credit institutions by the authorities has pushed this function into the background.

As an instrument of monetary policy minimum reserves have been in use in the US since 1933 and in Japan since 1957. In the European Community countries, minimum reserves are generally available as an instrument but in countries where developments in monetary aggregates do not receive particular emphasis they are no longer used. Ratios vary substantially from one country to the other with no reserve requirement in Belgium and only 0.40% in the UK on the one hand and Spain at 17% on the other. The base on which they are calculated and the degree of remuneration are also different. In France, they were introduced in 1967 with the aim to reinforce the Central Bank's control over money creation by commercial banks and to support interest-rate policy.

### 7.2.2 Functions of minimum reserves as an instrument of monetary policy<sup>1</sup>

The reasons for which minimum reserve requirements are used in France relate to the moderating effect on money creation by banks, the contribution to equilibrating demand for Central Bank money, the automatic smoothing effect on overnight money rates and the fact that they increase the credibility of monetary policy by conveying the message of the authorities. In particular:

- as demand for reserves is proportional to the development of bank activity, the Central Bank has the possibility to provide the amount of reserves it considers appropriate in view of influencing the course of monetary aggregates;
- demand for money base also gives the possibility to the Central Bank to regulate short-term market rates. This demand is determined by the difference between the available amount of currency and the factors creating money base (mainly Central Bank claims abroad and its position vis-à-vis the Treasury). The existence or increase of reserve requirements ensures that the amount of demand for Central Bank money is sufficient to allow it to exert the influence on short interest rates that may be required for the achievement of the aims of monetary policy;
- as bank reserves are calculated as an average over a certain period and given that they are not remunerated they exert a stabilizing influence on overnight rates. In effect, when liquidity increases and interest rates are pushed down, banks will add to their reserves bringing them to a level higher than the average ultimately pursued, in the hope to be able to depress them below average at a later time (in the same reserve period) when interest rates are higher. The opposite will happen when bank liquidity falls. Thus, an automatic inverse movement in the demand for banks takes place on each occasion, partly offsetting the primary movement of liquidity and, by consequence, relatively stabilizing the level of overnight rates;<sup>2</sup>
- observing the same function from a different angle, in the absence of a compulsory reserve requirement, interest-rate instability could result from the banks converting an excessively large part of their transactions (non compulsory) reserves into interest bearing assets. If this were the case, in the event of a sudden movement in liquidity, the Central bank would have to either tolerate erratic moves in interest rates or intervene in the markets and, possibly, compromise targets of monetary expansion;

1 Bulletin Trimestriel de la Banque de France", September/October 1990 and "Monthly Report of the Deutsche Bundesbank", March 1990.

2 Obviously this function looses in importance as the end of the reserve period approaches. In fact, just before the fifteenth of each month (which is, in France, the closing date for reserves) overnight rates often reach unusually high or low levels as banks find out that they have under- or overestimated the amount of required reserves.

- finally, to the extent that the authorities wish to reinforce the credibility of their monetary policy or to address a problem of short-term conflict between internal and external objectives, a change in the reserve requirement can be used in parallel with other means.

### 7.2.3 How useful are reserve requirements?

In spite of the apparent usefulness of minimum reserves as an instrument of monetary policy, a certain number of factors limit the scope of their utilisation, mainly as a result of the development and the globalisation of financial markets. In particular, the possibilities of dislocation and the progress of disintermediation are limiting the base on which reserves are calculated towards M1 which, in itself, is declining in importance. In addition, the development of new financial instruments and techniques could allow the Central Bank to exert the required monetary effect without imposing on the banks (and on the economy) the cost that the reserve requirements do.

In particular, as is the case with all instruments of monetary policy, the role of reserves in restraining money creation is limited by the possibility of private capital inflow in an open financial market. Moreover, the restraining function, if any, can also be played by the reserves that banks will hold independently of the obligation to do so, in order to face the needs of the transactions with their clients. Although the amount of those "transaction" reserves can vary with interest rates, among others, an increase in bank activity will increase demand for Central Bank money. Thus, the Central Bank will have the same, although somewhat more limited, possibility to restrain money creation.

The amount of demand for Central Bank money, adequate to allow it to exert the necessary influence on interest rates, is also a matter for investigation. In the recent years the demand autonomously addressed to the Banque de France (i.e. mainly through claims abroad and operations of the Treasury) was about FF 80 bn; this is matched by an equivalent amount of bank reserves deposited with it. In view of the regularity of the external position of the Banque de France over the past few years as well as the high level attained in public finance treasury management in France, compulsory reserves may be, to a large extent, redundant compared to what is needed for that purpose. Indeed, the autonomous demand for Central Bank money may be sufficient to allow the Banque to achieve the regulation it considers necessary. In addition, if that demand must be reinforced, the Central Bank can use the market instruments at its disposal.

By contrast, an increase in reserve requirements is indeed a powerful means to convey a policy message. However, in a context where monetary policy is severely constrained by the openness of the financial markets and by EMS, credibility is best transmitted through exchange-rate stability, i.e. interest-rate policy combined with the appropriate fiscal policy and supply-side arrangements. Therefore, utilization of reserves as a means of transmission of the policy message to the markets is a useful but not an indispensable instrument.

It seems unambiguous that reserve requirements indeed smooth out erratic day-to-day fluctuations of bank liquidity and, by consequence, excessive variability of overnight rates. In fact, in the countries where reserve requirements are not actively used, that rate fluctuates enormously. However, progress in market instruments and procedures could allow the Banque de France to check erratic fluctuations of bank liquidity and the overnight rate, without making recourse to reserve requirements. For example, the development of the practice of currency swaps and of issuing negotiable paper by the Banque de France can allow fine tuning of bank liquidity. Using those instruments requires a permanent presence of the Banque de France in the market.

The importance of day-to-day fluctuation of bank liquidity is a matter for the assessment of the authorities. Smoothing it out with reserve requirements must be weighted against the burden that the latter imposes on the banking system in the way of a transfer of profits to the Central Bank from the banks and/or from the economy as a whole. Indeed, reserve requirements add to the costs of intermediation and result to lower deposit rates, higher lending rates and narrower profit margins; thus channeling savings into investment by the banks becomes more difficult which affects the allocation of resources.

The lower deposit rates resulting from the imposition of reserve requirements constitute a direct incentive for depositors to move into other non monetary forms of savings; this is then translated into a slower growth of monetary aggregates. At the same time, savings are discouraged (but not the non-monetary savings), while the alternative forms of saving may be more difficult to monitor.

Disintermediation is an important factor limiting the use of reserve requirements. This is the case especially in France where financial innovation has made it substantially easier to turn to alternative sources of financial investment and financing of enterprises. In other countries, Germany in particular, where the possibility of non-bank credit creation is limited, reserve requirements can still remain at a relatively high level. Not only the spectacular growth of the OPCVM (Organismes de placement collectif en valeurs mobilières) provides an indication of such disintermediation (although this is hidden intermediation, to a certain extent) but, also the change in the financing behaviour of non-financial enterprises who are seeking more and more frequently non-intermediated credit (commercial paper) and equity financing.

Another serious constraint limiting the freedom of the authorities to increase reserve requirements at discretion is the international competition for savings in an open financial market. To the extent that the reserve requirement only concerns deposits with credit institutions installed in France, a high requirement ratio pushes deposits outside the country. Such is the situation that made it necessary for the French authorities to reduce, as mentioned in section 4, the requirement ratio of certain categories of deposits. One solution to the problem

could be to include those dislocated deposits in the base for calculation of reserves; but this would imply including also non-residents' deposits and this would reduce the attractiveness of Paris as a financial center.

As a result, reserve requirements in France are tending to concentrate on M1 which is, at present, more difficult to dislocate and to disintermediate. This bears now a requirement of 5.5% against 0.5% on the items included in M3-M2 and 2% on M2-M1. Moreover, this very aggregate (M1) is loosing in importance over time under the influence of alternative, relatively liquid forms of saving, in particular, due to the development of the OPCVMs. Thus, its part in the M3 was 33.7% at the end of 1990 compared to 37.3% at the end of 1987 and to 41% at the end of 1981.

"Offshore banking facilities" and "Euro-currency markets" in particular constitute an international, not only European problem. They enjoy major advantages (tax, regulatory, locational and scale) and, in addition, they are not subject to reserve requirements; as a result they have recorded a very rapid growth in recent years, in a context of free capital movements, upsetting to a large extent monetary policies and developments. As in France, other countries have had to take measures to counteract that phenomenon. Germany, in particular, included the accounts of foreign correspondents in the calculation of reserves and reduced the reserve coefficient on time deposits.

The problem of dislocation and, generally, the competitiveness impact of reserve requirements points to the issue of the need for a certain degree of harmonization at a wider European level.

#### 7.2.4 The reform of reserve requirements

Although they played a less significant role until 1986, reserve requirements contributed to the rationalization of bank management in France to the extent that they induced banks to develop a liquidity policy consisting in forming an opinion on future interest rates and in providing for liquidity flows. At the end of 1985, a new reserve system was put into operation as a transition towards a less closely controlled monetary framework. That system included in the reserve base, besides deposits, also the part of credit extension that was not covered by stable resources (mainly own capital plus bonds). That arrangement gave more freedom to the banks but mainly operated as an instrument of reform of the liability structure of the banks as it prompted an increase in stable resources and a reduction of their monetary financing.

The role of minimum reserve requirements was upgraded since the beginning of 1987, along with the definitive abandonment of credit controls and the adoption of a market-oriented monetary policy. The base was reformed and enlarged the ratio was increased and they were used as a full instrument of monetary policy providing the Central Bank with an additional degree of freedom for choice of policy.

The coverage of the system was extended to a much larger number of credit institutions, including also the savings and welfare funds, the *Caisses de Crédit Municipal*, the *Crédit National* and other special credit institutions to the extent that they carry out competitive activities.

From the point of view of the base of calculation, credit was completely excluded, which points to the abandonment of the formerly used system of the "encadrement du crédit". Reserves are now based on all demand liabilities (*exigibilités*) of residents with credit institutions denominated in francs (since 1989 the base includes residents' deposits in foreign currency with a zero rate), whichever their form. Are only excluded long-term savings (PEP and PEL) and certain assets designed essentially for popular residence (*Livrets A*).

The calculation of reserves is made on the basis of amounts outstanding in the books of credit institutions at the end of the month. In order to reduce as far as possible the gap between money creation and the corresponding increase in reserves, the period of reserves was fixed at one month (it was three months in 1985-86) and is the average of a four week period centered at the end of the month in question.

Reserves bear no interest; this contributes to the basic function of reserves, which is to smooth out very short rates. However, the same function could be performed if reserves were remunerated at any stable rate. Indeed, this would offset to a certain extent the problems created by the reserve requirements on the performance of banks and on interest rates.

#### 7.2.5 Utilization of reserve requirements

As the policy of credit controls (*encadrement*) was abandoned the ratios of reserve requirements were progressively increased, in 1985 and 1986, with a view to increasing demand for Central Bank money to the level considered by the authorities adequate for ensuring control over liquidity and interest rates. Thereafter, reserves were frequently used, in order to support monetary action. Since January 1987, ratios were modified on four occasions (see table below).

Table 16: Changes in reserve requirements

Ratios on	1986	Jan. 1987	July 1987	June 1988	Oct. 1989	Oct. 1990
M1	3.0	5.0	5.0	5.0	5.5	5.5
M2-M1	0.5	1.0	1.0	2.5	3.0	2.0
M3-M2	0.5	1.0	2.0	2.5	3.0	0.5
Change in amount of obliga- tory reserves (FF bn)	...	12.4	4.7	8.0	9.0	-26.0
total reserves (average end quar- ter) (FF bn)	49.5		60.5	65.5	75.3	(60.0)
in % of M3	1.5		1.7	1.7	1.9	(1.4)

- (a) In July 1987, the reserve requirement on items included in M3-M2 was increased from 1% to 2% and, at the same time, the repo rate was reduced by 0.25%. The two modifications cancelled each other in terms of burden on the credit institutions. In terms of monetary policy, the authorities aimed at shifting financial investment away from monetary and into bond markets and at frustrating investors who, anticipating an increase in long rates in bond markets, were turning towards money markets. As a result of this operation, the slope of the yield curve was improved.
- (b) In June 1988, considerations related to exchange-rate policy imposed a cut in official rates (taux directeurs) by 0.25%. As bank credit, to consumers in particular, was rising fast at that time, the reserve ratio on items included in M3-M2 and M2-M1 was raised to 2.5% with a view to neutralizing the effect of the rate cut and to avoiding an overheating of the economy.
- (c) In October 1989, monetary aggregates were rising fast in France. At the same time the Bundesbank initiated a general interest-rate rally by rising its rate by 1 point. The Banque de France followed with a rise of 0.75%. This was sufficient to maintain the parity against the DM but was not considered adequate on domestic considerations, so the opportunity was taken to proceed to a further increase in reserve requirements. Thus, the ratio on sight deposits was raised to 5.5% and the one on savings and time deposits was brought to 3%, resulting to an additional FF 9 bn of reserves.
- (d) In 1990, it was becoming more and more urgent to take action against large scale dislocation resulting from the abolition of all remaining exchange controls and from the development and the further opening of capital markets. Franc denominated time deposits, in particular, discouraged by comparatively large reserve requirements, were flowing out of France, placed with foreign banks. Eventually, those funds returned in France in the form of banks' liabilities to foreign correspondents thus canceling un-

favourable balance of payments effects, but on balance, financial activity in the Paris center suffered and the development of monetary aggregates was upset thus affecting the conduct of monetary policy.

Against this background, it was decided as of October 1990, to drastically reduce, from 3% to 0.5%, the ratio applicable on items included in M3-M2 which are easiest to dislocate. It was estimated that, under the conditions prevailing in the interbank market at that time, the burden on those items would be no more than 1/16 of a percentage point which seemed to be lower than the cost of dislocation. The measure successfully prompted the immediate repatriation of those deposits amounting at almost FF 90 bn.

During the same period, the monetary target variable, M2, was recording an unusually slow development owing mainly to the savings attracted by the unexpectedly successful Plan d'épargne populaire, a long-term government subsidized popular saving scheme, introduced in the beginning of 1990 and excluded from the monetary variables. This allowed the Banque de France to reduce, as of the same date, the reserve ratio applicable to M2-M1, from 3% to 2%.

A further measure mitigating the incidence of reserve requirements, taken at the same time, is the inclusion of banks' vault cash (encaisses) in the required reserves. This is also the practice followed in the main countries using the instrument of reserves.

As a result of those measures the amount of bank reserves held with the Banque de France was significantly reduced (by about FF 26 bn) which was readily repercutated to lower base lending rates with, however, little influence on overnight rates.

On the whole, reserve requirements were substantially increased since the operation of the monetary and financial system was reformed. As a result of the increase in ratios since 1985 the total amounts of reserves passed from FF 23 bn in the first quarter of 1985 to about FF 50 bn at the end of 1986 and to FF 70 bn at the end of 1987. The amount peaked at FF 82 bn in September/October 1990 but fell to less than FF 60 bn since the adjustment of the reserve system of October 1990. Required reserves represented, at the end of 1990 about 1.4% of GDP, a level which is lower than the one at the end of 1986.

#### 7.2.6 Conclusion

Minimum reserve requirements in France are aimed at moderating money creation by banks and equilibrating demand for Central Bank money. They automatically attenuate the variability of call money rates, which appears to be their main function, and reinforce the credibility of monetary policy by emphasizing the determination of the authorities. As those functions can also be performed by the market instruments of monetary policy minimum reserves seem to have a complementary

nature which should be weighted against the burden they impose on the financial system and, ultimately, on the allocation of resources in the economy. Moreover, the development and the globalization of financial markets are enhancing the possibilities of disintermediation and dislocation thus reducing the base of calculation and limiting the scope of utilization of minimum reserves as an instrument of monetary policy.

The role of reserve requirements has been reinforced following the reform of the monetary and financial system in France in 1986. Changes in reserve ratios have often been made, mostly in combination with changes in interest rates, contributing to the successful solution of monetary policy problems. Particularly important is the action taken in July 1987, which corrected the shape of the yield curve, and of June 1988 when exchange-rate induced interest-rate cut was combined with an increase in reserve requirements imposed by domestic consider-

ations so that a conflict between external and domestic objectives was resolved.

In response to successive monetary shocks reserve requirements in France were continuously increased until 1989. However, owing to the elimination of all remaining exchange controls and to the development of financial markets, competitiveness and monetary problems appeared in 1990 in the way of increased disintermediation and dislocation of deposits. As a result, the Banque de France proceeded to a drastic reduction in reserve requirements restoring, from that point of view, the competitiveness of the Paris financial market.

Financial innovation and market integration raise concretely the issue of harmonization in reserve requirements. The matter will have to be dealt with in the wider context of coordination of monetary policies.

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