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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 conjoncture, 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

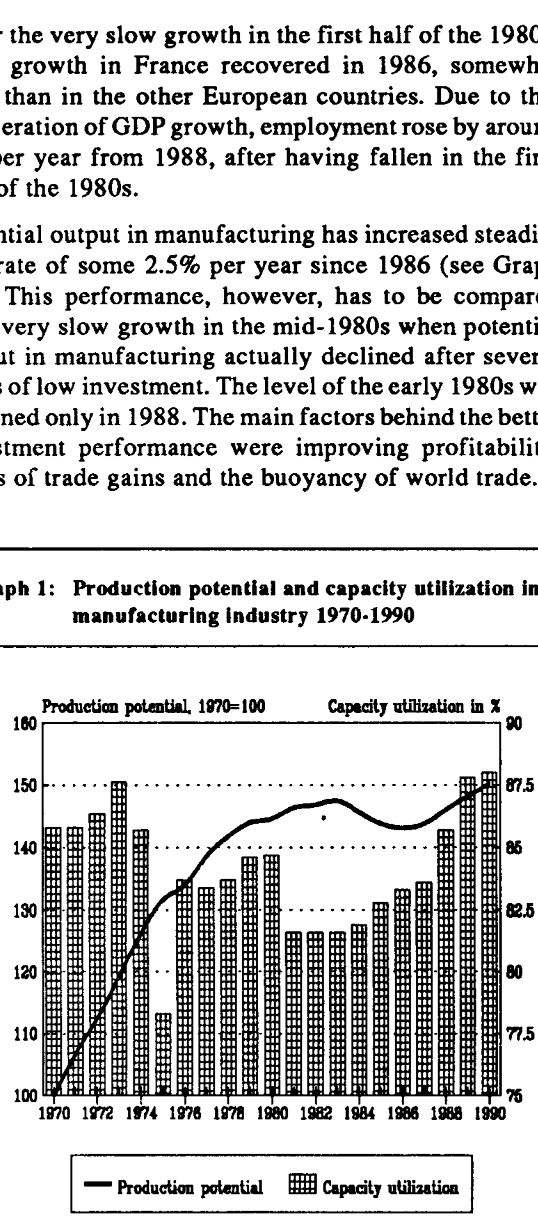
1. Macro-economic performances and policies

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) [1]. 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.

Graph 1: Production potential and capacity utilization in manufacturing industry 1970-1990



Source: Commission services
Own calculations

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

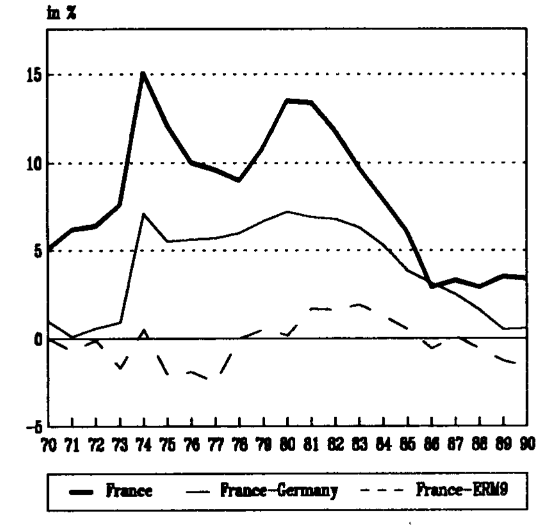
1 Potential output is here proxied by dividing value added in the manufacturing sector by the survey based figures on capacity utilization i.e. PO = VA.100/CU, where PO denotes potential output, VA value added in manufacturing industry and CU the survey based rate of capacity utilization.

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.

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



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

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.

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 ccount 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.

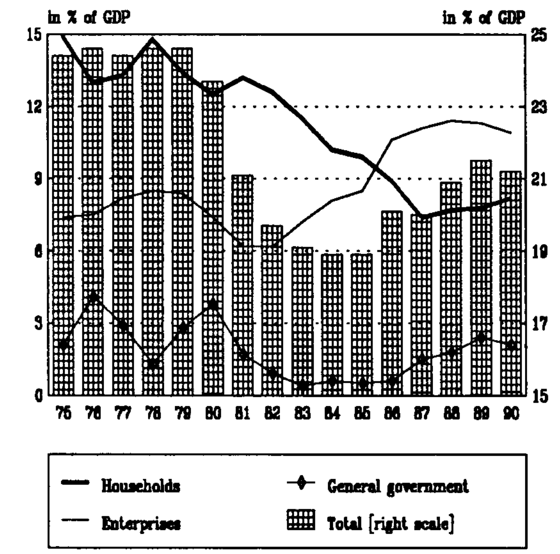
The liberalization of capital movements and the success which has been achieved in maintaining nominal stability have considerably reduced the need for balanced current accounts[1]. To the extent that current account imbalances reflect private sector, intertemporal decisions on saving and investment, 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

1 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

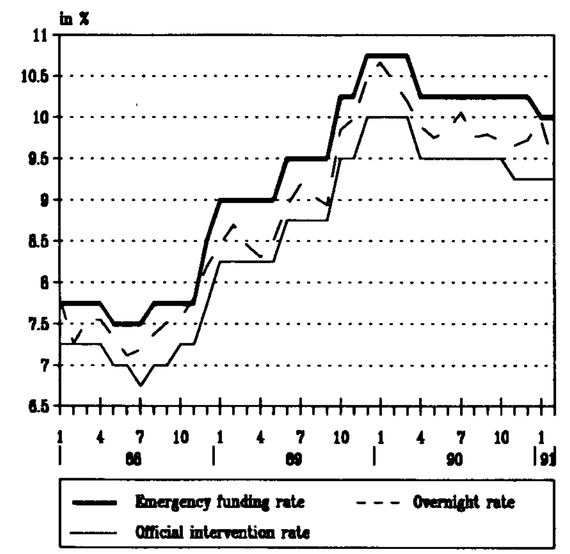
The macroeconomic framework in France has moved, since 1983, towards giving priority to price stability. Disinflation has been achieved among other things through exchange-rate stability vis-à-vis the DM and a non accommodating monetary policy, based upon increasing role of market mechanisms and budgetary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

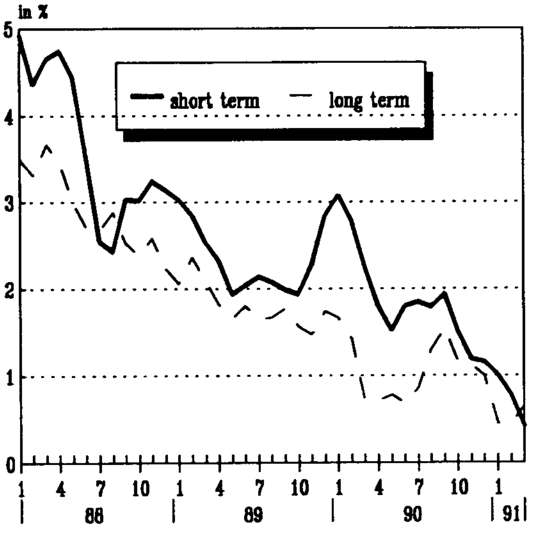
Until 1989, the performance of monetary targeting was by and large satisfactory; indeed, outturns were consistently in the lower segment of the target range. In 1990, financial innovations and an unexpected switch towards assets not included in money aggregates upset the development of the intermediate 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 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.

Graph 5: Interest rate differentials France-Germany



Source: Commission services

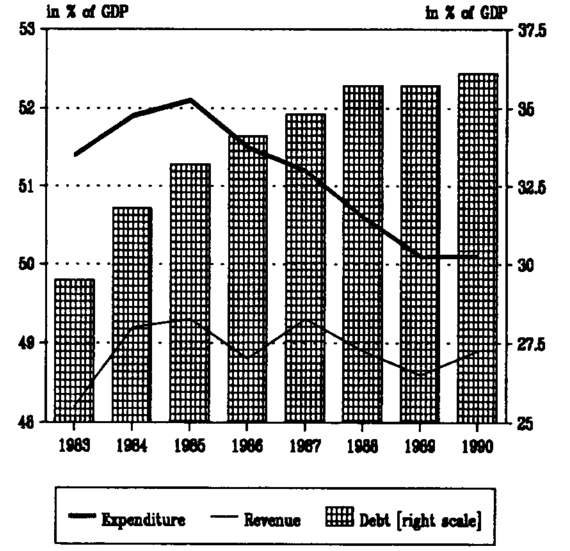
The most impressive results of French anti-inflationary policy can be seen in the drastically reduced interest rate differentials indicating a virtual disappearance of the relative risk-premium. Largely policy-determined short-rate differentials between the FF and the DM, which were as high as 5 points 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



Source: 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.