Chapter 3
Reflation and industrial policy in France

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The election of Mitterrand in May 1981 and the subsequent success of the Left in the parliamentary elections brought to power a government pledged to pursuing a policy of rapid reflation while effecting substantial structural and institutional changes in the French economy.

This chapter examines the short-term reflationary measures taken so far and considers their likely effect. It also examines the medium-term strategy which underlies institutional reforms currently being undertaken and assesses its chances of achieving sustained economic growth.

3.1 Some key features of the French economy

From 1960 to 1973 economic growth in France was both rapid and continuous. GDP grew at an average rate of 5½% a year as against 4½% a year in the EEC as a whole. The structural shift from a large agricultural sector to industry, a growing public sector, the success of indicative planning and the limited role of the French franc in international payments all contributed to high growth.

By 1973 the French economy had become an open, industrialised market economy. Value added in manufacturing accounted for 26% of GDP, while output in agriculture had fallen to only 5.5% of GDP (the figures for the UK in 1973 were 27% and 2% respectively). Around 25% of all manufacturing production was exported, while imports accounted for 20% of home market sales of manufacturs. The trade surplus in manufactures broadly offset the deficit on fuels.

Although the share of manufacturing output in GDP has remained constant since 1973, trade in manufactures has increased rapidly, with exports rising to 33% of output in 1980 and imports reaching 28% of home market sales. The trade surplus on manufactures did not, however, keep pace with the rapidly expanding oil bill; by 1980 it covered barely one third of an oil deficit equal to around 5% of GDP.

Increases in the price of oil highlighted the dependence of the French economy on imported energy. In 1973 France imported some 80% of its total energy requirements as against 56% in the case of Germany and 53% in the case of the UK.

The slowdown in the growth of the world economy after 1973 was particularly serious for France insofar as relatively high growth int in the labour force meant that more jobs had to be created than in the UK or Germany to keep unemployment down. Since 1973 growth of the labour force in France has averaged 0.9% a year as compared with a growth of 0.3% a year int he UK and a *fall* of 0.2% a year in Germany. Thus although total employment rose in France by0.3% a year between 1973 and 1980, unemployment increased steadily from 400 thousand to 1½ millions (over 6% of the labour force).

It should be noted that under Giscard d'Estaing's presidency in the 1970s economic policy in France became similar to that in other European countries as indicative planning, which had been a distinguishing feature of French policy in the 1950s and 1960s, was largely abandoned. It should also be noted that the sharp increase in world oil prices fed through into domestic inflation in France to a greater extent than in many other countries, emphasising the sensitivity of prices to external shocks.

3.2 1974 to 1981: the successive failure of two policies

In 1974 France had a large balance of payments deficit because of the increased cost of raw materials, high imports (fuelled by large pay rises in the period 1969-1973) and sluggish demand for exports. Inflation rose sharply to reach 17% in the first six months of 1974.

The Chirac government imposed price controls and first tightened, then eased budget policy. By mid-1976 unemployment had risen from just over 400 thousand to over 900 thousand, the balance of payments was still in substantial deficit, and the rate of inflation remained high at around 10%.

The failure of conventional demand management to cope with these problems led to a radical change of policy in mid 1976. The appointment of Barre as prime minister saw the start of a medium-term policy aimed at improving industrial competitiveness so as to increase the trade surplus on manufactures and theirby thereby ease the external constraint imposed by the oil bill.

The reasoning behind the policy was that increased competitiveness required higher investment and therefore higher profits. Loans and tax concessions were introduced to favour investment and exports while a nonetarist strategy of a balanced budget, low growth in the money supply and a strong exchange rate was imposed to control inflation, which it was believed had eroded profits in the past.

The results of these policies were disappointing. By the end of 1979 there had been no discernible increase in private investment despite a small rise in net profits.

The further rise int he price of oil in 1979 led to recession in 1980 and 1981. Industrial production fell by 9% in the year to April 1981. Unemployment increased by an unprecedented 21% between May 1980 and May 1981. Inflation climbed back to 13%, while real household income fell for the first time in twenty years. This was the background to the political changes in May 1981.

3.3 Mitterrand's policy assumptions and constraints

The Mitterrand government shares its predecessor's view that the present world recession is the result of a fundamental process of change in international trade and finance. Unlike its predecessor, however, the Mitterrand government attributes this change not only to the oil market but also to changes in the pattern of world growth.

This different diagnosis accounts, in part, for the differences in approach, despite a common aim of increasing competitiveness by encouraging investment in manufacturing. Barre's policy relied mainly on supply side and monetarist policies to bring about a market solution tothe problem of insufficient investment. In contrast, the Mitterrand policy is to use state planning to stimulate output of a well-defined range of products.

Barre's balanced budget policy led to increased borrowing from abroad by French firms, whereas the funds required for productive investment will now be partly provided by the government. As before, French multinational firms are to play a leading role in the modernisation of industry, but from now on under direct government control. Various types of planning agreement are intended to alleviate the balance of payments constraint, both by boosting export performance and by encouraging import substitution. One other key criterion in the formulation of policy will be the medium-term effect on employment, as achieving full employment is the main aim of Mitterrand's programme.

Since French planning had become weak in the 1970s, one of the major policy problems is to devise new planning instruments. It takes time, however, not only to implement new instruments, but also to judge the potential effectiveness of planning in what will remain essentially a market economy.

In the meantime the government (unlike Barre) is bound in the short term to undertake some reflation, even though it is aware of the limits that inflation and external deficits impose on what can be achieved by this means.

3.4 The short-term measures

To counter the recession, the newly-elected socialist government introduced some moderate short-term reflationary measures. These included increased family allowances and pensions, and a 10% rise in the minimum wage[1], raising total household incomes in a full year by the equivalent of 1% of GDP. Part of the resulting increase in wage costs was temporarily financed by the government.

Other elements of the package were a plan to create 55 thousand jobs in the public sector, the launching of a programme to build 50 thousand council houses through subsidised loans, and increased subsidies for certain energy-saving, job-creating or export-promoting investments. Taking account of a small rise in taxation which accompanied the reflationary measures, budgetary expansion amounted to 20 billion francs (0.7% of GDP)[2].

The budget deficit in 1981, however, is estimated to have increased much more than this, in total by 1½% of GDP, because of tax revenue being depressed by the sluggishness of the economy in the first half of the year.

Modest fiscal reflation was combined with a tight monetary policy, money supply growth being kept below the growth of nominal GDP. This and a small (3%) devaluation of the franc within the EMS illustrate the cautious nature of the package and emphasise the government's fear of fuelling inflation. Not surprisingly, the results in 1981 were modest. Unemployment continued to rise, exceeding 2 million (8½% of the labour force) in December, while inflation remained high at 14%. Although consumption grew by 2%, private investment declined by 4½% and GDP in total was only ½% higher than in 1980. The balance of payments deficit on current account amounted to 1½% of GDP.

The 1981 measures were, however, designed to buy time for the government to implement a fuller policy of reflation in the 1982 budget and the 1982-83 Interim Plan.

As in 1981, the 1982 budget will combine the expansionary effects of an increase in the budget

[1] The minimum wage directly affects 1.7 million wage earners and approximately one third of the increase is passed on to other wages.

[2] The figure is the difference between the draft 1981 budget and the amended budget in August 1981, and may therefore include some non-budgeted expenditure by the Barre government.

deficit with the redistributive effects of tax-financed growth in public spending. GDP is forecast to grow by 3%. Central government spending will be well over 13% higher in real terms than in the initial 1981 budget, but with increased tax rates the budget deficit is planned to remain more or less unchanged in relation to GDP.

Two of the more important consequences of increased public spending will be the creation of 71 thousand jobs in the public sector and a 40% increase in aid to industry. But despite this and the anticipated 3% growth of GDP, the policy will only succeed in keeping down unemployment (which requires about 200 thousand new jobs a year) if job sharing proposals are successful. These include a reduction in working hours, longer holidays, early retirement and youth opportunity schemes. The prospects for job sharing depend crucially on agreement being reached on incomes policy. The reduction in working hours from 40 to 39 hours a week has already raised questions about earnings, and it seems that satisfactory resolution of this issue at the level of individual firms will be central to the success of employment policy not only in the current year but also in the medium term.

From this perspective the period 1982 to 1983 will be a critical test of whether short-term policies will conflict with or reinforce medium-term policies.

3.5 The implementation of the medium-term strategy

The French government has begun its programme to change institutions and to enact legislation in order to provide a framework of instruments for medium- and long-term strategy.

Among the main changes are an enlargement of the public sector, revisions of labour law, a reformed national insurance scheme, a reshaping of the tax system and the setting up of a new decentralised planning process. Some of these changes will take time to set up (it will be two to three years before decentralised planning becomes effective) while others (fiscal reform) are still only under discussion. We concentrate here on changes which impinge directly on the principal goal of the medium-term strategy: the drive to reach full employment in an open economy highly dependent on imported energy. The following analysis focuses on three components of the strategy:

- a policy on employment which emphasises management of labour supply;
- an energy policy;
- an industrial policy which comprises three distinct elements: an enlarged public sector, a fully nationalised banking system, and sectoral planning agreements.

Labour supply policy[3]

As noted above growth in the labour force has, over the last ten years, been one of the distinguishing features of the French economy. Assuming present activity rates, the increase in working population alone will require the creation of 200 thousand jobs each year from now until 1985.

Although some of the job shortfall will be met by policies directly designed to create jobs, other measures aim to lower the need for work, either by reducing activity rates or by cutting annual hours worked. Because drastic policies to reduce activity rates (training programmes, child care allowances, or early retirement schemes) tend to discriminate against women[4], the young and the old, the emphasis in the Interim Plan is on job-sharing schemes and above all on a reduction in weekly hours worked. In the Plan the intention is to achieve a 35-hour week by 1985.

The effect on employment is uncertain. Past experience suggests that progressive reductions in working hours produce little or no discernible increase in jobs in the service sector, while the resulting increase in productivity in industry halves the impact on employment. Overall, only a third of the reduction in hours is likely to be transformed into increased employment. Nevertheless, assuming it is not eroded by increased overtime, a reduction of 5 hours in the working week might generate around 900 thousand additional jobs by 1985, enough to cope with the increase in the labour force.

This estimate, however, depends upon assumptions about productivity growth and wage restraint which may well turn out to be wrong simply because there is no recent experience of such a large reduction in hours within so few years. (In 1936, a large cut in *legal* hours of work produced no fall in *actual* hours worked.)

Energy policy

The burden of paying for imports of oil amounting to 80 per cent of energy requirements led the government in 1974 to launch a massive nuclear power programme. By 1990 nuclear power was expected to meet 30% of total energy needs and to generate 70% of forecast demand for electricity.

In October 1981 the new government decided to carry on with that programme. It chose to do so partly because much of the 1974 programme was already under way, with half the capacity expected to be in use by 1984. Reduced scope for energy saving also influenced the decision, as did the

[3] Measures aimed at specific groups of workers, such as youth employment schemes or the 'national solidarity' contract, are not discussed here as they influence the structure of the labour market rather than add to total employment.

[4] The participation rate of women is already comparatively high in France and its growth rate is now one of the lowest in Europe.

likelihood of unavoidable delays in exploiting alternative energy sources.

The prospects for energy saving seem bleak because the ratio of energy consumption to GDP in France, already the lowest in the EEC in 1973, has been cut proportionally more than in most other countries. In the Interim Plan a strengthened energy saving policy is only expected to reduce the level of energy consumption forecast for 1990 by 4%.

Although the nuclear programme will have a considerable effect, it will only bring the dependence of the French economy on imports of energy down to the European average.

Planning and industrial policy

The need for an industrial policy is the central motivating force behind the medium-term strategy. In France, as in many other open industrialised economies, the world recession has severely affected manufacturing industry. Employment has fallen and the trade surplus in manufactures has diminished relative to the cost of imported raw materials and fuel. The UK has already suffered over two decades of industrial decline and a similar process is now evident, though to varying extents, in most other European countries. Import penetration has increased steadily while exports have been hampered by the slowdown in world demand, with the result that even the more successful countries have found it difficult to expand their surpluses on manufactured trade . Reduced growth in both internal and external demand has depressed the growth of industrial output and reduced employment. (Industrial output needs to grow by around 5% a year in France to prevent employment from falling.)

The loss of jobs tends to be concentrated in old industrial areas, in which the process of decay spreads from industry to subcontractors and then to the service sector. Moreover, since the initial loss is the result of a lower trade surplus, the scope for expansion and job creation in other sectors is limited.

Against this background the government has chosen to stress the importance of industry in the dynamics of growth. Industrial policy will be aimed at restructuring industry through planning in order to improve manufacturing competitiveness.

The policy consists of three elements: more nationalisation of industry, full nationalisation of the banking sector and sectoral planning agreements.

(i) Nationalisation in industry

The nationalisation programme has so far raised the share of publicly-owned industry from 11% of GDP to 17%. In addition to the two largest steelmakers, which account for 80% of steel production, five other large industrial combines have been brought under public ownership. These companies which operate extensively outside France (49% of their turnover is generated abroad and 30% of their 656 thousand jobs are located outside France) are expected to become the backbone of the industrial strategy. Although they will continue to operate under market rules, the intention is for their boards and the government to agree on a four-year set of targets for employment, investment and product lines in accordance with the goals of the central indicative plan. The companies will be reorganised and encouraged to specialise in order to strengthen their already dominant positions at all stages of the production process in certain areas of the chemical, electronics and pharmaceutical industries, in particular.

The companies use high technology production methods requiring substantial investment, which in the past few years has caused acute financial difficulties. To ease their problems the government plans to increase their capital substantially (by 30 billion francs) over the next five years. Their technological lead, which will be sustained by an expansion of publicly funded research and development[5], is viewed as a central factor in the drive for competitiveness.

(ii) Nationalisation of the banks

Although nearly all the banking sector will be publicly owned, the 39 nationalised banks will be expected to compete with each other over a full range of services as regards both lending and borrowing, whereas previously some banks specialised in taking deposits while others specialised in financing business activity.

Apart from their role in administering national schemes to provide credit for investment and consumer spending, banks will be expected to operate more at the regional level to finance small and medium-sized firms[6]. Their support of small business will help the implementation of sectoral planning agreements.

(iii) Planning Agreements

So far, sectoral plans have been formulated for vulnerable industries like leather, toys, furniture, machine tools, paper and board, ship-building and textiles, all of which have been hit by import penetration. In the initial stage of the plans, the emphasis is on the 'reconquest' of home markets.

These rescue plans are similar to those tried in the past in steel, textiles and machine tools but are more comprehensive. The methods adopted

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[5] Public R & D expenditure is set to rise from 1.8% of GDP to 2.5% by 1985.

[6] One new technique being tried is to offer loans which take the form of venture capital where the interest rate varies according to profits.

include organising markets for raw materials (leather), participation in the funding of enterprises that will provide research and leasing support for the industry, subsidised loans, public procurement (machine tools), and the setting up of marketing networks, especially for exports.

In return for this kind of support, the industry boards have to agree to avoid redundancies and accept negotiated reductions in imports. The planning agreement is thus based on mutual self interest rather than on compulsion.

The basic philosophy of the sectoral plans is that no sector need be abandoned entirely as there will always be opportunities for efficient firms to specialise in particular products. The strategy thus aims to do more than simply delay unavoidable decline.

In most respects, the medium-term strategy follows a pragmatic rather than a doctrinaire approach. The following section considers the risks involved and assesses the chances of success.

3.6 The prospects for policy in the short and medium term

In the short term (1982-83) the target of 3% growth in GDP together with no change in unemployment stands a good chance of being achieved.

Although there had been fears of a run on the franc, a collapse in investment or an acceleration in inflation, any of which could have delayed recovery for some time, none of these has yet happened.

If the forecasts for the budget deficit and the external deficit turn out to be correct there now seems to be little danger of a run on the franc. The budget deficit is expected to amount to 2½% of GDP, which compares favourably with an EEC average of 4%. Similarly the external deficit, at 1½% of GDP, is not excessive, and the fact that monetary policy is intended to be tight should favour the franc. Although inflation is expected to remain at 14% in 1982, which may lead to some minor realignment of the franc, the EMS provides some protection from speculative pressure, as do exchange controls imposed from mid 1981.

The reluctance of private sector firms to invest is a more immediate danger to the strategy. In 1981, when slow growth of 0.5% coincided with uncertainty about the future direction of the economy, private investment fell by about 7%. After such a drop, there are grounds for believing that private investment will recover, aided to some extent by the rise in consumer spending. The first fruits of the sectoral plans and the more accessible finance from the newly nationalised banking system should encourage investment by small businesses, while a more favourable demand outlook might stimulate companies to replace a capital stock whose average age has risen after ten years of low investment.

The danger of increased inflation certainly remains present. No incomes policy has yet been agreed between the government and the three main groups – farmers, wage earners and the self employed.

The government has tried to introduce a scheme to link pay rises to a target rate of price increase with wages being adjusted retrospectively. Though pay claims so far have been relatively modest, the success of the scheme will probably depend on its ability to differentiate between high and low income groups. Income inequality, both before and after tax, is remarkably high in France and provides scope for favouring low income groups. In future, special measures for low-paid workers are likely to be an essential ingredient of an incomes policy if it is to succeed in moderating wage claims – though if erosion of differentials goes too far, it may well provoke resistance on the part of skilled workers.

A more immediate inflationary threat comes from farmers seeking price rises to compensate for the decline in their incomes over the last five or six years. This is a matter for EEC negotiation under the Common Agricultural Policy and it remains to be seen how the issue will be resolved.

Given its commitment to keep down price rises, the government will certainly continue its policy of price control while these inflationary pressures persist.

So far as the prospects for industrial strategy are concerned, difficulties may arise either from the pragmatic nature of the policy or from external constraints such as the Treaty of Rome or GATT which limit France's freedom of action.

The pragmatic approach of the industrial strategy makes it difficult to assess its likely effects. Sectoral plans appear so far to have been largely rescue schemes, while the form that nationalisation has taken has been governed more by political than by economic considerations. Even the cost of the industrial policy is hard to assess as changes continue to be made to compensation proposals in the nationalisation plans and the sectoral plans are being altered in response to emergencies. What can be said, however, is that the policy lacks central direction and may be hampered by international liabilities.

Central planning is to be integrated with regional policy which will itself have to await devolution of power to the regions. There will, therefore, be a one- to two-year delay before planning can become an effective instrument. There is a strong risk that by then most of the initial decisions will have been taken, since the reorganisation of newly nationalised industries will have to occur without delay in order not to damage their competitive positions.

The absence of a well thought out central direction to policy may mean that the newly nationalised groups continue with market-oriented policies, thereby diminishing the capacity of the public sector to secure significant changes. Moreover, the piecemeal nature of the sectoral plans, which are already under way, makes it difficult to compare the policy costs with likely benefits in terms of trade or employment. There are doubts too about whether planning agreements will be adhered to in the absence of consumers' agreeing to restrictions on cheap imports.

International constraints on the policy are obvious. They arise both from treaty obligations and from the size of the French economy.

The increasing deficit on manufacturing trade with modern industrial countries like the US, Germany and Japan is a growing cause for concern. To be competitive France needs to introduce new technology and exploit economies of scale. But the latter may be difficult to achieve, in view of the size of Japanese companies and the increasing importance of restrictive trading practices in the US in response to Japanese competition. For the five newly nationalised companies to reach the targets set for them they may, consequently, have to enter into joint ventures with foreign firms. There are signs that French policy will be to encourage cooperation with other European firms but there may be some reluctance on the part of European multinational corporations to enter into partnership with nationalised industries. Furthermore, the scope for joint ventures may be limited by the relatively high proportion of European industry owned by foreign multinationals (up to 45% in Belgium and Germany, 25% in France and 15% in the UK).

Limits imposed by international obligations may prove to be even more stringent. In particular, the policy aim of reconquering domestic markets will, in a context of slow growth, have damaging effects on the exports of some countries. (The Italians have estimated that the French plans announced so far will cut their exports by 4 billion francs.) Even if the action is concentrated on a limited number of products, there is bound to be an effect on the total exports of other countries. The effect is likely to be felt most in other European countries specialising in products which the French government is seeking to promote. To overcome this difficulty the government is trying to get the general strategy of reconquering home markets adopted at the European level as has happened with multi-fibres or steel. But this will take time.

Certainly, any relaxation of the external constraint on the French economy will require medium-term action by the EEC as a whole, not only in the form of industrial policy reform but also in the form of reflation. It is doubtful whether any sufficient move in this direction will be taken. In these circumstances, the industrial policy may turn out to be less effective than anticipated. The time needed to set up central and regional planning mechanisms and to negotiate sectoral plans or joint ventures at the European level may impose severe limits on what can be achieved and the medium-term strategy may have to be regarded as a long-term one whose benefits can only be realised gradually.