Overview

For the second consecutive year, world growth was very strong in 2004. Following the collapse of the Iraqi regime, world trade, especially with Asia, posted a sharp increase, while growth picked up throughout the world. However, there were contrasts between individual zones in the upturn in activity, which was strong in the United States, Japan and the United Kingdom but tenuous in the euro zone.

The United States recorded brisk growth, underpinned by the budget deficit and by deliberately accommodating monetary policy. Somewhat more unexpectedly, Japanese growth also picked up strongly. The Chinese economy, fuelled by substantial inflows of foreign investment and driven by extremely vigorous exports, continued to expand at a very firm rate, bringing the rest of Asia along with it.

In the euro zone, the upturn was moderate. The appreciation of the euro's effective exchange rate continued to affect sectors exposed to foreign competition. Domestic demand picked up but unevenly between countries, with household behaviour remaining very cautious in several countries, notably Germany and Italy.

Outside the euro zone, economic policies, which had been particularly expansionist since mid-2003, underwent a certain gradual tightening during 2004. This change of course took place in the United Kingdom in November 2003 and in the United States in June 2004. Starting in Q2, China also tried to curb the expansion of investment through measures to restrict borrowing.

World trade accelerated distinctly between mid-2003 and mid-2004 before later slowing down. For the year 2004 as a whole, the increase in volume was 9.9 %, compared with 4.9 % in 2003[1]. At the same time, the growth in economic activity led to substantial tensions, notably a rise in the oil price accompanied by high vlatility and also a sharp increase in prices of industrial raw materials. These tensions tended to curb world growth in the second half of the year.

In the case of France, it was private domestic demand, especially from households, that underpinned the recovery. Productive investment was still moderate at the end of 2003, but household consumption was brisk in 2004 (up 2.0 %) and housing investment, boosted by low interest rates, continued to make progress (3.1 %), against a background of sharply rising real estate prices. Overall growth was nevertheless held back by a disappointing tendency in exports, which were restricted by the cumulative appreciation of the euro in the previous two years and the weakness of domestic demand in France's main European trading partners (Germany and Italy), while at the same time imports rose strongly (by 6.9 %). The balance on trade in goods and services (fob-fob) deteriorated to the point of being barely positive (down to € 4.2 billion from € 17.6 million in 2003, the lowest level since 1992).

After posting three successive annual slowdowns, the French economy showed an improvement between mid-2003 and mid-2004, before again slowing down in the second half of the year. Having been unable to preserve market shares following the apprecia-

1. Source : IMF.

tion of the dollar, French exporters were immediately affected by the slowdown in world trade. However, households underpinned total demand, at the cost of reducing their savings and raising their borrowing. Growth on an annual average basis came out at 2.3 %, but with a distinct slowdown in the second half.

Firms tended to rebuild their inventories, but restricted their initiatives regarding investment following a slight pickup towards the end of 2003. With the process of reducing the working week coming to an end in 2002, the rise in productivity per job seems to have converged with the trend growth in hourly productivity, i.e. 1.7 %. Moreover, firms tended to adjust their workforces to fluctuations in demand in a manner that was smoothed over time : having reduced them only moderately during the recession phase in 2003 (by 0.5 %, year on year), they increased them only slightly in 2004 (by 0.2 %, i.e. 35,000 jobs) in the face of tenuous and uncertain recovery. In the market-sector branches in general, and even more in the case of manufacturing industry, productivity rose strongly and unit costs slowed down. Despite the rise in energy and commodity prices and the acceleration in wage costs per job, profit margins of non-financial enterprises rose slightly (by 0.2 of a point). Meanwhile, the number of start-ups rose strongly for the second year running.

Inflation remained at a rate of 2.1 % on an annual average basis, following a short-lived acceleration in the early part of the year. The main items tending to maintain its rate were petroleum products and tobacco. Core inflation also remained stable (1.6 %), but the household consumption deflator accelerated to 1.8 % from 1.3 %.

Given the absence of any rise in employment, the unemployment rate remained high despite slower growth in the labour force. However, the rise in the average wage per full-time job accelerated in the market-sector branches (to 2.5 % from 1.9 %), notably because of a substantial rise in the guaranteed minimum wage in July 2004. In addition, investment income picked up strongly and the rise in tax payments, based on income and assets in 2003, slowed down. In the end, disposable income rose by 3.2 %, substantially faster than in 2003, and purchasing power increased by 1.4 %.

In these circumstances, household demand was lively. For one thing, households took advantage of the low level of interest rates by continuing to raise their spending on investment in housing (by 3.1 % in real terms, following 3.9 %). In addition, growth in their spending on consumption was slightly firmer than in 2003 (up by 2.0 % compared with 1.4 %) and the household saving ratio continued to decline despite the acceleration in purchasing power growth. Growth in publicly-financed consumption, although slowing down, continued to provide backing for growth in effective consumption.

The recovery has meant an acceleration in the taxes received by general government (up 4.9 %). Current taxes on income and wealth paid by households slowed down (to 2.4 % from 3.3 %), but the growth in consumption stimulated VAT receipts, while corporation tax benefited from the profit recovery. On the other hand, despite the rise in interest rates, effective social contributions moved relatively slowly (up 3.1 %) because of the weakness of the upward tendency in wage incomes.

Overall, the burden of compulsory contributions rose slightly (to 43.4 % of GDP from 43.1 %). Two-thirds of this increase was the spontaneous result of the upturn in activity and one-third stemmed from the introduction of new measures. Meanwhile, the rise in public expenditure slowed down (to 3.6 % from 4.2 %) and was therefore less than that of GDP. In the final analysis, the public deficit was reduced (to 3.6 % of GDP from 4.2 %), but this was still above the target set in the Growth and Stability Pact. The public debt continued to increase, reaching 64.7 % of GDP by the end of the year.

A mixed upturn in the euro zone

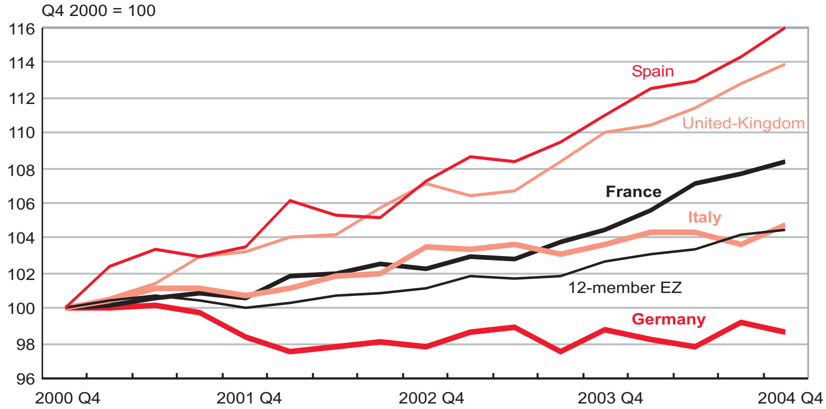
Euro-zone GDP rose by 1.8 %, compared with 0.5 % in 2003. The tendency in the first half was a prolongation of the upturn begun in mid-2003. The zone benefited from the vigour of world trade and from a pause in the appreciation of the euro. In the second half of the year, the European economy was hit by the slowdown in world trade, the renewed depreciation of the dollar and the initial impact of the rise in the oil price

The growth upturn posted simultaneously by the various euro-zone countries in H2 2003 and H1 2004 was very mixed. Growth was based on firm domestic demand in France and — as ever — in Spain and on foreign trade in the case of Germany. In Italy, both these components were relatively slack and the upturn was sluggish.

Whereas consumption by French households (showing a rise of 2.9 %, year on year, in Q2 2004) benefited from wage growth and improved confidence, growth in Germany was handicapped by the weak rise in household spending at a time of wage restraint and restrictions on social transfers and also by industrial restructuring. The boost given to the construction sector by strong demand for housing was also a support factor in France and Spain, whereas in Germany the contraction in the sector continued, the result being wide divergence between the evolutions in domestic demand in the three countries.

Graph 1

Domestic demand in Europe in volume



Definition : Domestic demand in volume, Q4 2000 = 100
Source : Eurostat, Newcronos.

Conversely, particularly brisk exports made a substantial contribution to German growth up to the middle of 2004, whereas foreign trade made a negative contribution to growth in the French case.

Generally speaking, the upturn in growth failed to bring about a decrease in unemployment in the euro zone. The upturn in production was slow to have an impact on employment. This phenomenon is usual in the early part of an upturn, with firms initially tending to make better use of their existing workforces before stepping up recruitment. As long as the growth rate remains moderate — as was the case for a year — the increase in production can be handled with an unchanged workforce. As a result, unemployment rates have failed to decline, generally speaking, while rises in earnings have remained small at a time when the rise in the oil price was having an impact on inflation. The only factor making a real contribution to a rise in household disposable income was the reduction in taxes in certain countries (France, Germany), but consumer behaviour remained generally cautious nevertheless.

The clean-up of company balance sheets in the previous two years enabled the upturn in activity to lead to a timid recovery in investment towards the end of 2003, but there was no intensification of this tendency in 2004, with investment in the euro zone rising roughly in line with GDP. It is possible that the cumulative appreciation of the euro over several years held back the recovery in investment by reducing the demand outlook for a given level of profitability.

Inflation in the euro zone (harmonised basis) was 2.1 %, the same as in 2003, after peaking at 2.3 % in 2001 and 2002. Despite the slowdown in growth and the decline in the dollar seen since 2001, inflation in the euro zone as a whole turned out to be highly inert. There nevertheless continued to be a certain dispersion of inflation rates within the zone, despite monetary union. Some countries experienced a marked peak (Belgium in 2000, Germany, Austria and the Netherlands in 2001) followed by an appreciable decline until 2003 — even 2004 in the case of the Netherlands. In France, inflation has risen slightly since 2000. Despite the economic upturn and the continuing moderately restrictive fiscal policies, the reduction in the public deficit of the euro zone on the Maastricht definition has been very small, from 2.8 % of GDP in 2003 to 2.7 % in 2004.

The past appreciation of the euro and the rise in the oil price have restricted growth

The rise in the oil price has had two unfavourable effects on the euro zone : a direct inflationary effect and a depressive effect on activity (see Table 1). It will be noted that the second of these effects operates to a large extent through a reduction in world demand. In the absence of the rise in the oil price, world growth would have been much more vigorous.

Exchange-rate movements in 2004 had only a limited influence on euro-zone growth in that year. The euro in fact appreciated only slightly during the year (by 3.6 %). With inflation lower in the euro zone than in the rest of the world, the euro's real effective exchange rate (adjusted for inflation differentials) appreciated by only 2.4 %. Furthermore, this appreciation took place entirely towards the end of the year : after peaking early on, the European currency depreciated in March and April and then rose again in the final quarter. The impact on annual GDP was therefore slight, given the delayed reaction on the part of the economy.

Table 1

Consequences of a 100 % rise in the oil price in the space of six quarters with real interest rates and exchange rates constant

Difference in percentage points

	France (MESANGE model)*	Euro zone (MZE model)*		
After an ierval of	**One year**	**Two years**	**One year**	**Two years**
Oil price	66.6	100	66.6	100
World demand	-0.8	-4.5	-0.3	-4.0
GDP in volume	**-0.4**	**-1.4**	**-0.2**	**-1.5**
Year-on-year change in import prices	3.4	3.8	8.0	3.3
Commercial terms of trade	-0.8	-1.5	-1.2	-1.8
Of which. contribution from import prices	-0.9	-1.9	-1.3	-1.9
Inflation (year-on-year change in consumer prices)	0.8	1.2	0.7	0.7
Consumption	-0.3	-0.8	-0.6	-2.2
Investment	-0.7	-3.0	-0.5	-3.3
Imports	-0.9	-3.7	-1.8	-7.5
Exports	-0.7	-3.8	-0.3	-3.8

(*) Mésange and MZE models and world demand modelled as a function of the oil price and exchange rates (see French version)

How to read the table : a 100 % rise in the oil price reduces French GDP by 0.4 % at the end of four quarters and by 1.4 % at the end of eight quarters. Year-on-year growth is accordingly reduced by 0.4 % in the first year and by 1.0 % in the second.

On the other hand, the euro zone continued to feel the effects of the sharp appreciation that had taken place between Q2 2002 and end-2003 (amounting to roughly 20 %). This lagged impact results from the fact that the volume of foreign trade adjusts only after a time to variations in prices. As a result, the past appreciation of the euro continued to contribute to the deterioration in the zone's trade balance in 2004. Using the MZE model, an evaluation was made in the previous document in this series that the impact of this appreciation was to reduce growth by 0.5 of a point in 2002 and by 1 point in 2003. Using the same instrument, the residual impact of this past appreciation is estimated at 0.4 of a point on growth in 2004 : the impact on the contribution of foreign trade to growth is put at -0.6 of a point, but the disinflation linked to the same appreciation is estimated to have had a positive impact on domestic demand, notably consumption (+ 0.5 of a point). As it turned out, inflation measured by the price index remained highly inert, being underpinned by the rise in the oil price.

Upturn in the French economy

The French economy experienced an upturn in 2004, with growth estimated at 2.3 %, compared with a slack year in 2003 (+ 0.8 %). This performance is modest in the light of the strong world growth but is nevertheless above the EU average. The first half of the year marked a continuation of the sharp upturn begun in Q3 2003, but activity slowed down distinctly in H2.

The year 2004 saw French growth driven by domestic demand, with household consumption (up 2.0 %) providing the main support for final demand : against a background of renewed growth in their real incomes, households continued to reduce their saving ratio. This dynamism was helped by low interest rates and by an expansion of lending. The liveliness of household demand was even more manifest in the case of housing investment (+ 3.1 %, compared with 3.9 % in 2003), helped by the decline in interest rates and the lengthening of the duration of loans.

Foreign trade again made a negative contribution to growth (0.9 of a point) and the external surplus virtually disappeared. Exports, driven by the acceleration in world demand, picked up (+ 3.1 % in volume compared with -1.7 % in 2003) but France again lost market share and suffered from slack demand in its main European neighbours, notably Germany, the Netherlands and Italy. Imports, for their part, reacted sharply to the upturn in domestic demand, with a rise of 6.9 % in volume. Competition from France's European neighbours was stimulated by excess productive capacity and, in the case of Germany, by the low rate of cost increases, while imports from third countries were stimulated by the recent rise in the euro.

Investment by firms (non-financial enterprises and individual entrepreneurships) rose by 2.8 %, having stagnated in 2003 (+ 0.1 %). Given the fierce foreign competition on both the domestic and export markets, firms increased their investment in France in order to meet the rise in demand only to a moderate extent, despite the improvement in their financial situation. On the other hand, stock build-up was substantial after the destocking in 2003 and this contributed 1.0 of a point to growth. Whereas stocks of agricultural products were reconstituted following the exceptional weather conditions in 2003, manufacturing firms seem to have allowed themselves to be taken by surprise by the sudden slowdown in demand that took place in the middle of the year.

Employment rose very little in the non-farm market-sector branches, by 44,000 on a full-time equivalent basis[2] between Q4 2003 and Q4 2004, or just 0.2 %. As usual, the adjustment of employment to the acceleration in production was only partial and took place after a certain timelag, the result being accelerated growth in labour productivity (2.1 %) following the pickup in 2003 (1.2 %) in the period of virtual stagnation. With the process of reduction in the working week coming to an end in 2002, the evolution in productivity per head seen in the past two years (1.7 % a year) is now once more in line with the trend evolution in hourly productivity that had prevailed between 1995 and 2000. Meanwhile, the average wage per full-time job accelerated (to 2.5 %, year on year, from 1.9 % in 2003) stimulated mainly by an accelerated increase in the statutory minima. With the burden of social contributions also rising, the improvement in the non-financial enterprises' profit ratios was only limited (0.2 %).

2. In other words, counting two half-time jobs as one full-time job.

Inflation, measured by the consumer price index, remained stable (2.1 % on an annual average basis) under the impact of opposing influences : upward in the case of oil and tobacco prices; downward in the case of the past appreciation of the euro, the 4.4 % decline in prices of fresh produce and, more marginally and on a one-off basis, by revived competition in the large-scale distribution sector. Core inflation also remained stable, at 1.6 %. However, the household consumption deflator accelerated to 1.8 % from 1.3 % in 2003 because of the somewhat exceptional evolution in prices of FISIM (financial intermediary services indirectly measured) in 2003 (see Box 1, p.21).

Virtual disappearance of the external surplus

Despite a rally in exports at the end of 2003 and the beginning of 2004, the deterioration in the external balance accelerated in 2004. External trade made a negative contribution to growth for the second year running (0.9 of a point in 2004, 0.6 of a point in 2003). The external balance on goods and services came out at € 4.2 billion compared with € 17.6 billion in 2003[3]. In just two years, the external surplus, which had been continually positive since 1992, virtually disappeared, with merchandise trade showing a deficit of € 6.6 billion and the surplus on services continuing to contract (to € 10.7 billion from € 14.3 billion in 2003). The energy deficit (cif-fob) widened by € 5.9 billion to € 27.9 billion, while the surplus on manufactures continued to decline (to € 6.4 billion euros from € 10.2 billion), as did that on agricultural products to a certain extent.

The disappointing foreign trade performance stems from a deterioration in the export/import ratio in volume terms. Despite the rise in the oil price, the evolution in prices in general reduced by roughly one billion euros the deterioration of the balances in value terms, as France benefited from a distinct improvement in the terms of trade in manufactures.

Taking the year as a whole, exports in volume terms rose much less rapidly than world trade, being hit by a geographic allocation giving pride of place to European markets and relatively little to rapidly-growing Asian markets. Exports also suffered market share losses as a result of the deterioration in price-competitiveness built up over the previous three years. French exporters found themselves having simultaneously to face increased competition from the United States (stimulated by the recent fall in the dollar) and from Germany and the Netherlands (benefiting from drastic cost-cutting). Imports by contrast reacted strongly to growth in domestic demand, rising by 6.9 %).

Since the end of the year 2000, French exports in volume have moved less favourably than those of the euro zone as a whole

In 2004, French exports of goods and services rose less rapidly in volume than those of the euro zone (up 5.5 % including intra-zone trade). A similar gap in performance had already occurred in 2001 and 2003. Since Q4 2000, in fact, French exports have risen by only 1 %, whereas those of the euro zone rose in the same period by more than 8 %. However, the French situation is not exceptional and remains more favourable than that of Italy.

3. Customs statistics show a trade deficit of € 7.8 million. This is partly because they record imports on a cif basis and exports on a fob basis. They also do not take into account the balance from tourism (see the special article entitled "The national accounts move to the 2000 base", to be published in due course on the web site).

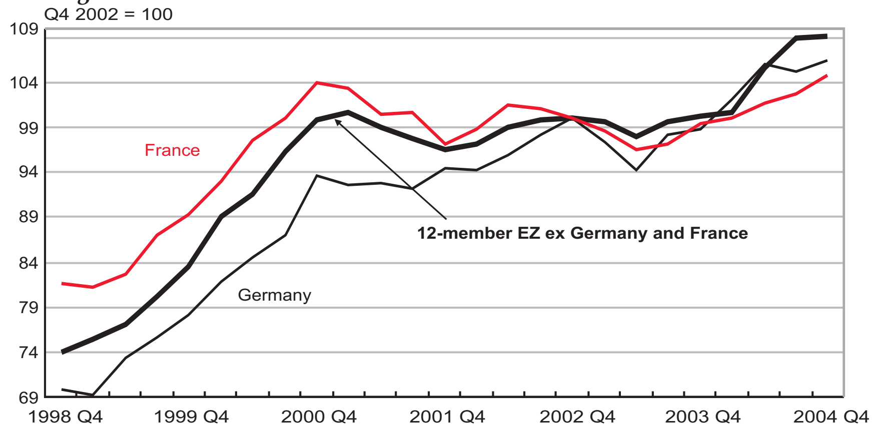
Within the euro zone, Germany continues to stand out for the performance of its exports, which rose by 7.5 % in 2004. Since 2001, German exports have risen more rapidly than those of the zone as a whole, those of France and Italy more slowly. Between end-2000 and end-2004, the cumulative differential between the evolution in German exports and those of the euro zone amounted to 7 % and the differential vis-à-vis French exports came close to 15 %.

In value terms, it is since 1999 that French exports have been rising less rapidly than those of the euro zone. On the other hand, on this basis the German outperformance shows up much less distinctly than the French underperformance and is to be seen mainly in 2001 and 2002. Between end-1998 and end-2004, the cumulative differential between the rise in German exports and those of the 10 euro-zone countries other than France and Germany amounted to only 3.5 %, while that between French exports and these 10 countries amounted to - 13 % (see graph 2).

The upturn in German exports at the beginning of 2003 and the subsequent levelling off in mid-2004 preceded movements in the same direction for exports of the 10 other euro-zone countries, while at the same time French exports were rising much more inertly.

Graph 2

Exports of goods and services in value terms



Sources : Source: Eurostat, Newcronos.

Between end-2000 and end-2004, the euro-zone countries, despite their weak growth, increased their imports in value at a faster rate than France (1.7 % annually compared with 1.0 %). This suggests that cyclical differentials between European partners (between France and Germany especially) are not the only cause of the loss of dynamism by French exports compared with these same European partners (notably Germany). The geographic and sectoral specialisations of French exports and those of its partners partly explain these performance differences. The restructuring of the productive system following the shock of German unification and a more far-reaching integration of the Central and Eastern European countries (CEEC), involving a greater amount of relocation of production, are also very likely explanations for the German performance.

From 2001 to 2004 world growth rose in volume at an average annual rate of 4.6 %.

Given the geographic structure of French exports, demand for French exports (or perceived as such) rose by only 3.5 % (Deruenne, 2005)[4]. Between 2000 and 2002, the euro zone, the United States and China were, in that order, the three geographic regions making the largest contribution to the difference in performance between German and French exports in value (4.4 % per year)[5]. Bilateral trade between France and Germany contributed 0.6 of a point to the difference and the other euro-zone countries 1.1 of a point, the United States 0.5 of a point and China 0.4 of a point. Between 1997 and 2002, German exports to China more than doubled, whereas French exports stagnated. However, these results are unstable over time. If the year 2003 is included, the annual performance differential is reduced to 3.3 points and the contribution of the euro zone is reduced to 0.4 of a point, of which only 0.1 of a point is accounted for by trade between Germany and France. On the other hand, the contribution of the four CEEC becomes substantial (0.5 of a point instead of 0.3).

This is because German exports to the CEEC are much more substantial than those of France and have been expanding more rapidly. The ratio between the German and French shares of the Polish, Czech and Hungarian markets is 5 to 1. In 2003, these countries accounted for only 3.6 % of French merchandise exports and 3 % of its imports ex energy (Louvot et al. 2004). Although French trade with these countries is in surplus and growing, the expansion and opening up of the CEEC economies are benefiting German exports more than French exports.

Between 2000 and 2003, plant and machinery and transport equipment were the two sectors making the largest contribution to the difference in performance between German and French exports, as Germany has built up a better position than France in these sectors of the fast-growing economies. Since mid-2003, Germany has been quicker to take advantage of an upturn in investment that was stronger in countries outside the euro zone. In these branches, French exports are highly dependent on winning major contracts (nuclear power stations, large-scale transport investment) that are irregular by nature. For the remainder, the inertia of French exports has resulted from the fact that they are directed more to other European countries, where domestic demand has been slack, and from the fact that French sectoral specialisation is less clear-cut and gives more prominence to consumer goods and agricultural products, for which demand is traditionally more inert.

Over the medium term (2001-2004), the evolutions in prices of French, German and euro-zone exports have been very similar, whereas those of Italian exports showed considerable divergence (+ 2.5 % per year). In 2004, prices of German exports stagnated while those of France and the euro zone as a whole continued to rise (by 0.8 %). These small differences may reflect an improvement in German competitiveness, but they may also be the result of sectoral specialisation that was temporarily less rewarding in the case of German exports. Evolutions in prices in 2004 in fact differed widely, depending on the individual products.

4. In order to isolate the impact of geographic specialisation, it is normal to construct a global indicator of demand for French exports by weighting the imports of each country by its share of French exports. The calculation made by the DGDPTE takes imports in volume of 40 countries , weighted by their share of French exports in 1996 (source : the CHELEM database).
5. Calculations made using the OECD STAN database (L'Angevin and Serravalle, 2005).

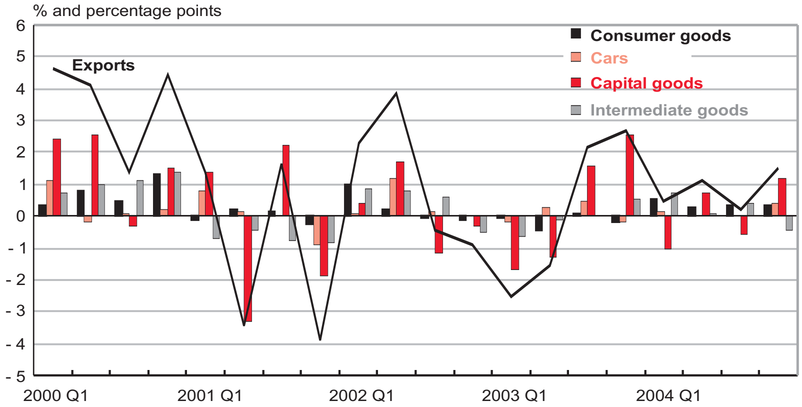
Capital goods have set the pattern for export growth

Taking the year 2004 as a whole, exports of manufactures rose by 5.3 % in volume (after falling by 1.9 % in 2003). Exports of capital goods contributed 2 points of this growth and intermediate goods 1.5 of a point. Traditionally, orders for capital goods and intermediate goods are the most cyclical components of demand and the way they move tends to determine the pattern for trade in industrial products as a whole. In mid-2003, the upturn in exports was triggered by a sharp recovery in sales of capital goods, which had fallen steeply the previous year. Exports of consumer goods and cars also showed a recovery. On the other hand, exports of intermediate goods rose very little in volume.

In 2004, tendencies in prices applied in international trade differed considerably from one product group to another : in the case of consumer goods, the decline in export prices resumed at the beginning of the year (for an average annual decline of 1 %), but there were distinct recoveries in prices of cars (+ 4.6 % following - 1.8 %) and in intermediate goods (+ 2.5 % following - 1.6 %).

Graph 3

Contributions to the evolution of exports of manufactures in volume



Source : Insee, national accounts - 2000 base.

When the assessment is made in value terms, annual growth in exports of manufactures (6.6 %) is also the result of the upturn in H2 2003. The early part of 2004 saw a levelling off in the export growth rate, with exports of capital goods no longer rising from Q1 on and exports of cars as of the following quarter. All that remained was modest growth in exports of consumer goods and intermediate goods. The final quarter showed more balanced growth between the various sectors, but this was due to divergent price movements.

Since the end of 2000, the only sector to have posted substantial growth in export value was cars (22 % in four years). Growth in exports of consumer goods was weak (8 %), while neither exports of capital goods nor those of intermediate goods had regained their end-2000 levels at the end of 2004. The car industry indubitably represents a strong point in French specialisation, but growth in car exports remains modest in relation to world growth, especially as it is due in part to higher prices (+ 6 %). While French carmakers have increased their market share in the world as a whole, they have also — like large firms in other sectors — increased their production located in other countries (see the special article on relocation, available in French only).

In 2004, French imports rose faster than those of its European partners

French imports of goods and services leapt by 6.9 % in volume in 2004, having been virtually stable in 2003. This growth rate is roughly one percentage point above that of German imports or those of the euro zone. The opposite situation had prevailed in 2003, when French imports barely rose (+ 0.7 %), German imports rose by more than 4 % and those of the euro zone by more than 2 %. The differences seen in 2004 do not seem excessive in view of the existence of distinctly more dynamic domestic demand in France (see graph 1, page 3). Exports in value moved more in parallel.

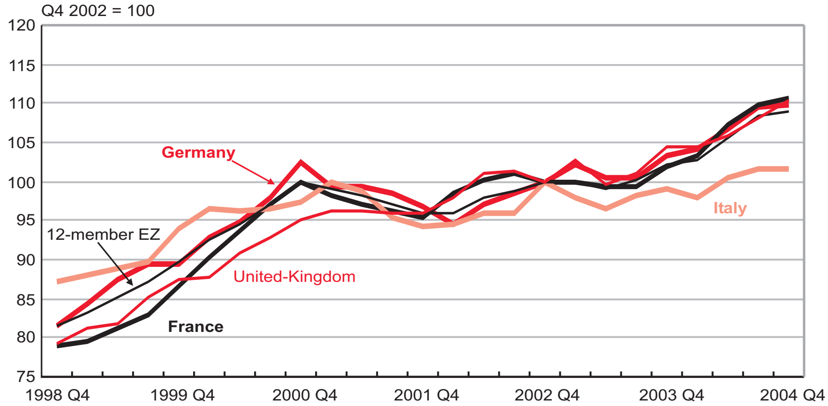
Although certain differences are to be seen in the short term, as shown by the annual movements, the evolutions since the end of the 1990s in imports into France, Germany, Italy and the euro zone, and even the United Kingdom, have been very similar, taking either volume or value. To be more precise, imports by France, Germany and the euro zone have moved virtually in parallel in both value and volume. The convergence in terms of volume has been particularly marked since 2001 (see Graph 4).

Since 2001, United Kingdom imports in volume have also converged with those of the euro zone. In value, however, a gap has opened up since the beginning of 2003 because of the appreciation of the euro against sterling. In the case of Italy, the evolution of imports in value has been very similar to that of the euro zone, but the evolution in volume has been slower on a trend basis while the rise in prices has been stronger, also on a trend basis.

These evolutions suggest that France may not have suffered from the weakness of domestic demand in its two principal customers, Germany and Italy; both France and Germany seem to have been disadvantaged by the slow growth in the volume of Italian imports, but this disadvantage is not to be found in the value calculations. However, the

Graph 4

European imports of goods and services



Sources : Eurostat, Newcronos.

additional French imports were used mainly in order to meet growth in final demand, while the additional German imports were more generally the result of relocation of production outside the euro zone (notably in the CEEC) and are used more for intermediate consumption and exports.

Sharp rise in imports of manufactures

Imports of manufactures rose strongly in 2004 (by 8.1 % in volume) after stagnating in 2003.

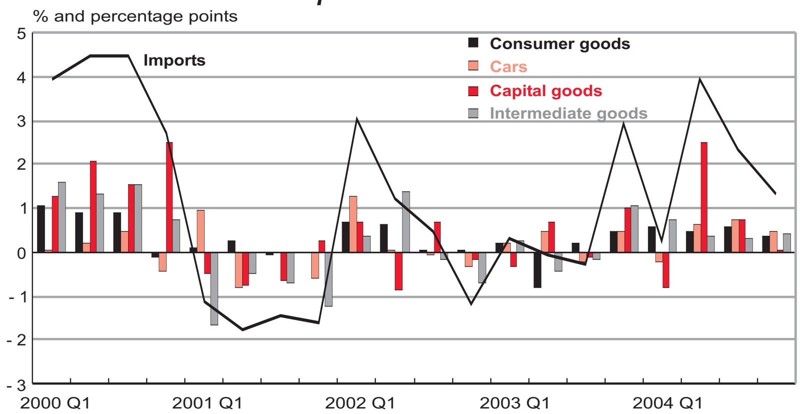
The upturn in imports made itself felt at the end of 2003 and involved all components of demand at a time when firms were stepping up their investment to a small extent and no longer destocking and when it was household consumption that was underpinning demand. Subsequently, although growth in corporate investment continued at a slow but steady pace, imports of capital goods seesawed (see graph 5). The contribution from intermediate goods reflects the strong recovery in industrial activity as of mid-2003 and a slowdown during 2004. This contribution, which was still positive at the end of the year, illustrates the fact that economic activity has continued to make progress, but at a slower rate. The contribution of consumer goods, which was positive throughout the year, reflects the support given by household consumption to overall demand.

Recovery in prices and stability in terms of trade

Over the year as a whole, export prices of manufactures rose slightly (by 1.3 %) after falling by 5 % in the previous three years. The upturn in demand and the slower decline

Graph 5

Contributions to the evolution of imports of manufactures in volume



Source : Insee, national accounts – 2000 base.

in the dollar made it possible to raise prices in the case of cars, while the commodity price rise and worldwide pressures on productive capacity led to export price rises in the case of intermediate goods. Meanwhile, import prices of capital goods and consumer goods continued to fall rapidly.

Finally, despite the rise in the oil price, France raised its export prices by slightly more than the rise in import prices it was obliged to accept (+ 1.9 % compared with + 1.7 %).

The additional revenue derived from this differential was around one billion euros, having been of the same order of magnitude in 2003 and € 10 billion in 2002.

The rise in oil prices between 2003 and 2004 cost € 4.7 billion on a full-year basis, or 0.3 of a GDP point. When all energy products are taken into account, the cost of the deterioration in terms of trade was limited to € 3.3 billion, given that France is an exporter of electricity and nuclear fuels.

In the case of manufactures, the terms-of-trade gains amounted to € 2.5 billion, compared with € 1.8 billion in 2003 and € 4.2 billion in 2002. Gains were made in consumer goods, cars, capital goods and intermediate goods.

Strong acceleration in stock building but only a slight upturn in investment

The acceleration in stock building has contributed substantially to growth

Firms rebuilt their stocks on a substantial scale in 2004, having run them down in 2003. This acceleration in stock building contributed 1 percentage point to the evolution in GDP.

Generally speaking, stocks serve as a protection against unforeseen events affecting production or sales. When such an event occurs, stock levels are modified accordingly. Thereafter, production or purchases are modified in order to bring stocks back to what is seen as a more desirable level. This desirable level is assessed in the first place in relation to the flow of new orders, but it can also evolve as a function of the cost of stockholding.

The heatwave in the summer of 2003 badly affected production of agricultural and food products, with the result that stocks of these products were drawn down substantially or even eliminated. In 2004, the stocks were rebuilt, entailing a sharp rise in agricultural production, combined with a decline in consumption and deterioration in the external balance on food and agricultural products. In the final analysis, the acceleration in the build-up of stocks of agricultural and food products accounted for 50 % of the total acceleration in stock building in volume. However, given the decline in their prices, stocks of these products made relatively little contribution to the overall rise in stocks in value terms.

In industry, the revival of demand in mid-2003 would logically have been expected sooner or later to be reflected in a need for higher stock levels. However, as it turned out, the growth in demand turned down sharply in Q3 2004, possibly catching some firms off-guard. This may be a partial explanation of the substantial stock build-up in the car industry.

In the case of capital goods, on the other hand, an upturn in sales led to a reduction in stocks that was larger than in 2003. In the shipbuilding, aircraft construction and railway equipment industries, the production cycle is spread over several years and this has a major impact on stock behaviour. For example, the delivery in December 2003 of the Queen Mary II liner was reflected in an export item of € 688 million and a decline in stocks of the equivalent amount. Conversely, the build-up of production of the A380

Airbus contributed to positive stock formation.

The acceleration in stock building of intermediate goods and energy products is quite distinct, with these products contributing 30 % of the overall acceleration in stock building in volume terms and, given the rise in their prices, the bulk of the acceleration in value terms. Low interest rates and substantial price rises for the products concerned acted as an incentive for building up stocks.

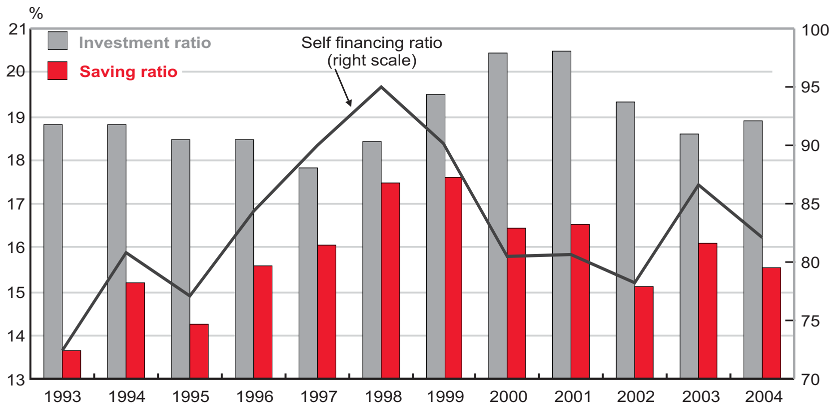
A modest upturn in investment

Investment in France by non-financial enterprises and individual entrepreneurships rose moderately in 2004 (by 2.8 %) after stagnating in 2003 (+ 0.1 %) and actually declining in 2002 (by 2.9 %). However, this upturn, which had begun at the time of the revival of order books in Q3 2003, ran out of steam in H2 2004 while at the same time growth in demand slowed down.

Overall, the upturn in corporate investment that began in mid-2003 turned out to be modest. In the last major upswing phase, between 1998 and 2001, firms had stepped up their investment at a rate that was twice that of GDP growth. The period since mid-2003 has seen nothing similar, with corporate investment rising barely faster than demand. Despite the upturn in new orders, unutilised productive capacity has remained generally adequate to meet unforeseen shifts in demand and only occasional adjustments in capacity have been called for. Furthermore, the growth outlook for the euro zone remains weak and heterogeneous and in these circumstances multinational groups are rationalising their production in Europe, making the best possible use of their unutilised capacity in regions where demand is relatively slack in order to supply more buoyant markets such as the French.

In 2004, major groups have continued to give priority to reducing their debt and not to expanding their activity, while others have used part of their cash holdings for the purpose of buying back their own shares. Financing conditions were, however, particularly advantageous throughout 2004. Business leaders themselves are of the opinion that the

Graph 6
The financing of investment by non-financial enterprises



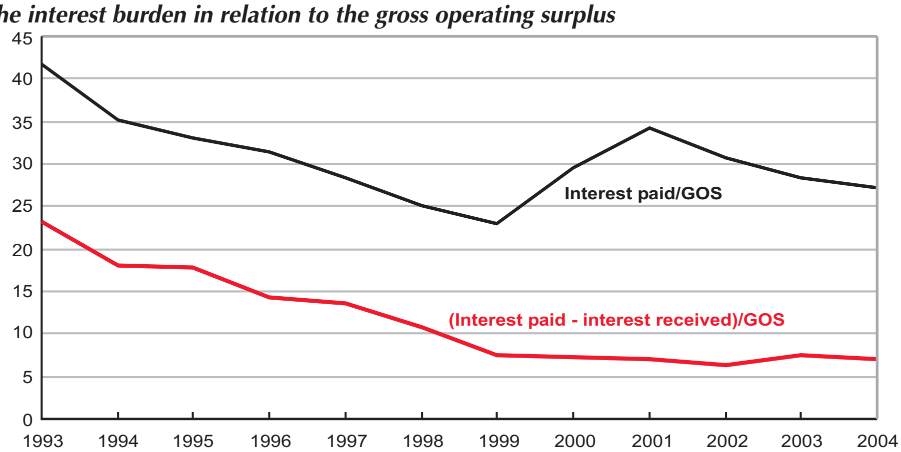
Source: Insee, national accounts – 2000 base low level of interest rates has made debt financing more attractive. Not only have long rates on government bonds fluctuated in a very low range (between 3.6 % and 4.4 %) but premiums paid by firms have also been low (roughly 60 basis points). At the same time, share prices on the asset markets were relatively non-volatile and represented a fairly correct valuation of the firms concerned, but growth prospects remained poor for the euro zone.

The upturn in investment by the non-financial enterprises and individual entrepreneurships in 2004 mainly involved plant and machinery (up 4.6 % compared with 1.7 % in 2003) and automobiles (+ 3.5 % compared with - 6.7 %). Investment in business services, which include software, continued to rise (+ 3.9 % compared with + 3.0 %), but investment in buildings and public works has remained slack (+ 0.6 % compared with - 0.1 %).

At 18.9 %, the investment ratio for non-financial enterprises has risen slightly after declining in the two previous years. Although the upturn in investment is still tenuous, the investment ratio has since 2001 remained constantly higher than that seen in the previous cyclical trough in 1997 (see graph 6). The saving ratio has been declining, leading to a fall in the self-financing ratio. In fact, while the recovery in the profit ratio remains limited (a rise of 0.2 of a point to 30.9 %), non-financial enterprises have given priority to dividend distribution over self-financing : net distributed income was equivalent to 7.1 % of value added, compared with 6.5 % in 2003. The historically low level of interest rates in fact makes it easier for firms to finance investment through additional borrowing.

Graph 7

The interest burden in relation to the gross operating surplus



Source : I nsee, national accounts - 2000 base

Note : In the 2000 base, interest margins paid by firms to financial intermediaries on their borrowing and their deposits are treated as intermediate consumption and no longer as part of either their value added or their gross operating surplus. As a consequence, interest payments and receipts are calculated excluding margins. At macroeconomic level they represent the direct cost of the borrowing by non-financial enterprises and do not include the cost of services obtained from financial intermediaries. This new approach reduces by roughly 2 points the ratio of gross interest payments to gross operating surplus and by roughly 5 the ratio of net interest payments to gross operating surplus.

The burden of financial charges has stabilised

In 2004, interest payments by non-financial enterprises were equivalent to 27.2 % of their gross operating surplus and net payments (after deducting interest received) 7.1 %. The fall in the interest payments burden in the past two years, despite the build-up of stocks in 2004, is explained by the decline in interest rates and a high level of self-financing. The rise in their gross operating surplus accordingly led to a reduction in the interest burden. In 2004, nevertheless, the growth in the non-financial enterprises' debt (by 4.5 %) was slightly faster than that of value added.

Limp recovery in manufacturing industry excluding agri-food industries

The year 2004 was characterised by an upturn in exports, investment and stock building, by the relative support provided by household demand and by a slowdown in public spending. In these circumstances, manufacturing activity, taking the full brunt of the deterioration in the trade balance, grew more slowly than service activities.

The pickup in activity was flabby in the manufacturing branches (excluding agri-food) where value added rose by 1.6 % in volume whereas it had declined by 1.2 % in 2003. Only the consumer goods industries, taken as a whole, recorded appreciable growth (2.9 % following 1.2 %). The car industry was in stagnation (+ 0.2 %) following a year of recession (- 3.0 % in 2003). In the capital goods and intermediate goods industries, which had also seen two years of recession, the recovery was limp (+ 1.5 % and + 1.4 %).

In manufacturing industry, the shift in the producer price tendency went beyond merely passing on rises in prices of inputs, the result being an upturn in the price of value added (by 1.3 %) following a decline of 1.5 % in 2003 and continuous erosion since 1990.

The rise in the price of value added was particularly marked in the production of combustible fuels (7.0 % following 8.8 % in 2003), but the price of value added fell in the production of electricity (by 4.2 %).

The upturn in industry was reflected in accelerated purchases from service companies. In the business services sector, value added picked up sharply (+ 3.2 % following + 0.7 %). On the other hand, it tended to be eroded in the case of personal services (- 0.5%), while the rise in the price of value added (3.4 %) remained well above the inflation rate.

Return to normal in agriculture and the agri-food industries

In 2003, agriculture had been badly hit by unfavourable weather conditions that had held back activity, pushing prices up and volumes down. The return to normal in 2004 was reflected in a steep rise in value added in real terms (+ 11.8 % following - 11.6 %) accompanied by a similarly steep fall in prices, with value added remaining stable in value terms.

In contrast, food-processing industries posted a fall in volume (by 2.7 %) following a steep rise in 2003 (+ 3.4 %). In value terms, their value added continued to be eroded (- 1.5 % following - 1.0 %).

Continued growth of activity in construction

Value added in the construction branch (including public works) slowed down slightly (+ 2.5 % in volume), having recovered strongly in 2003 (+ 3.7 %) following a small recession in 2002 (- 1.4 %). For the third year in a row, this branch of activity benefited from a distinct acceleration in prices (+ 7.2 %, following + 5.4 % and + 4.6 %), indicating pressures on productive capacity and, in particular, recruitment difficulties.

Construction firms' GFCF barely accelerated while that of general government slowed down. Households' housing GFCF, which includes both purchases of new housing and renovation of existing housing, continued to make strong progress (+ 3.1 % in volume following + 3.9 % in 2003), but nevertheless slowed down in a climate of sharply rising prices.

For several years now, in fact, rising incomes and declining interest rates have led to strong growth in demand for housing on the part of households. Faced with this demand, the housing stock has adjusted only slowly, with the scarcity of building land and recruitment difficulties in the building sector restricting growth in the production of housing. In addition, the annual production of housing is small in relation to the stock, the result being sharp rises in the price of building land[6], in promoters' margins and in the prices of both new and existing housing.

No improvement in total employment

Dependent employment remained stable at 22,054,000 full-time equivalent (FTE) jobs (a rise of 1,000) between Q4 2003 and Q4 2004. During this period FTE employment rose by 44,000 in the market-sector branches (following a decline of 86,000 in 2003) but it declined by 43,000 in services (mainly non-market-sector services). Nevertheless, given the increase in the number of part-time jobs, the number of people with a job rose by 34,000 (+ 0.1 %) to reach 22,708,000 by the end of the year, having fallen by 63,000 in 2003.

On an annual average and FTE basis, total employment, taking all branches together, fell by 34,000, following a fall of 25,000 in 2003. This means that the upturn in activity between mid-2003 and mid-2004 led to only a modest change in the employment tendency. Employment in the mainly market-sector branches stabilised (+ 3,000) but employment in the mainly non-market-sector branches, which had risen by 26,000 in 2003, fell by 37,000 in 2004. Despite the slowdown in activity in the second half of the year, labour productivity rose in the market-sector branches after tending to decline somewhat the previous year. In fact, adopting their usual behaviour, firms did not immediately adjust their workforces to the evolution in demand but applied a smoothing over time.

Employment policy had a neutral impact, overall, on market-sector employment flows in 2004. The mechanism for the reduction in social security charges for the lower-paid

6. For several years now, prices of housing GFCF on the part of households have been evolving more slowly than the prices of housing. Household GFCF in fact includes a substantial portion of renovation work (roughly 40 %). Moreover, purchases of new dwellings are valued at the price of construction, excluding the acquisition of the sites on which they are built. Since these sites are not produced goods, trade in building sites is recorded separately in the capital accounts. In pratice, a substancial portion of the rise in the price of housing purchased by households results from a rise in the prices of building land.

(the so-called Fillon arrangements[7]) that had been introduced as of July 2003 gradually eliminated any incentive for our reduction of working hours, with neutrality announced for July 2005. At the same time, the costs induced by the unification of the different hourly minimum wages were almost entirely compensated by the redefinition of the coverage of reductions in contributions, so that the two measures taken together had no impact on the overall level of employment. Moreover, the number of workers benefiting from special arrangements rose slightly, as the build-up of the "Initiative emploi" (employment initiative) and "Jeune en entreprise" (company youth employment) contracts was not sufficient to offset totally the impact of terminations of the arrangements involving reduced contributions for part-time work. However, the difference (7,000 in 2004) was much smaller than in 2002 and 2003. Overall, taking account of windfall effects, the net impact of specific assistance arrangements on the evolution in market-sector employment is put at –2,000 in 2004 compared with around -35,000 per year between 2001 and 2003.

Despite the weak upturn in activity, the decline in employment intensified in manufacturing (- 2.8 % on an annual average basis following - 1.2 % in 2003), while employment picked up in construction (+ 2.1 % following - 0.1 %) and in mainly market-sector services (+ 0.7 % following - 0.1 %). This differentiation reflects a structural gap between the evolution in productivity in manufacturing and in the other branches.

In the mainly non-market-sector branches, the decline in employment stemmed for the most part from the reduction in the number of people benefiting from the various programmes of assistance to non-market-sector employment (302,000 at end-2004 compared with 483,000 two years earlier). This evolution marks a break with a long-term tendency, in that non-market-sector employment, having doubled since 1970 had, following the reduction in working hours, continued to rise until 2003. For the most part, the fall in employment in the non-market sectors took place in government service, where the workforce fell by 0.3 %, but it was also felt in the organisations having private status (firms or Non Profit Institutions Serving Households – NPISH) working in these branches (private clinics, for example). As result, employment outside government service fell by 0.1 %, taking all branches together.

Strong recovery in productivity

The slowness with which employment adjusted to the upturn in activity was reflected in an acceleration in productivity per job (see Table 2), especially in manufacturing. In 2004, the recovery in total productivity was partly the result of the unusually large number of working days in the year, which had an impact of + 0.2 of a point. The growth in productivity was also the result of employers' usual practice of smoothing over time the evolution in numbers employed in relation to production needs in order to minimise the costs of adjusting their workforces. Finally, it also resulted from a return to a trend growth rate of the order of 1.7 % a year following the ending of the reduction in working hours.

7. Extension of the reductions in social contributions to all the lower-paid and unification of the separate versions of the hourly minimum wage (see "The French economy 2003-2004").

Table 2

Growth, productivity and unit wage costs (1)

Annual average changes, %

	2001	2002	2003	2004
Market-sector branches				
Wages per head (2)	1.9	2.6	1.9	2.5
Social contribution ratio	- 0.4	- 0.1	0.4	0.1
Productivity per head (2)	- 1.3	0.1	1.0	2.4
Unit wage cost	2.8	2.4	1.3	0.1
Manufacturing industry				
Growth rate of value added	1.8	- 0.3	- 1.2	1.6
Productivity per head (2)	0.4	3.5	0.0	4.5
Unit wage cost	0.6	0.2	3.8	- 1.6
Other market-sector branches				
Growth rate of value added	1.9	2.0	1.1	2.6
Productivity per head (2)	- 1.7	- 0.8	1.1	2.0
Unit wage cost	3.4	3.1	0.8	0.6

Source : Insee, national accounts - 2000 base

(1) This table does not take into account the impact on the cost of labour of the reform of the business tax.
(2) Full-time equivalent basis

What happened was that the usual link between growth and productivity per head was temporarily broken by the process of the reduction in working hours which was spread over the period from 1999 to 2002. In the non-farm market-sector branches, the theoretical working week for full-time workers declined by 7.2 % during this period. When allowance is made for the usual lags in the adjustment of employment to growth, the slowdown in growth between 2001 and 2003 would normally have led to a slight increase in productivity per head. However, the slowdown and finally the termination of the reduction in working hours in the end led to an acceleration in productivity per full-time job in 2002 and 2003 despite the weakening of growth.

In manufacturing industry, growth in productivity per full-time job picked up again in 2004, exceeding the long-term trend figure of 4 % that had prevailed from 1978 to 1998 and which had persisted until 2000 despite the introduction of the shorter working week. Despite the interruption in growth between 2001 and 2003, manufacturing firms had only partially adjusted their workforces to the decline and so productivity per head on an FTE basis rose much less.

The acceleration in productivity per head was much less marked in the non-manufacturing market-sector branches. In these branches, which account for almost 80 % of market-sector value added, the trend growth in productivity is very small, but growth is much more stable. The ending of the reduction in working hours enabled the rise in productivity to be resumed and the growth acceleration in 2004 was weaker and had less impact on productivity.

However, the distribution of value added between branches depends partly on statistical conventions, so that it is necessary to treat with caution the persistent differentials in the evolution of productivity (see the special article on productivity in «The French Economy 2004-2005).

Slowdown in unit wage costs

The increase in unit wage costs was only 0.1 % in the market-sector branches, compared with 1.3 % and roughly 2.5 % the two previous years. In manufacturing industry, unit wage costs declined, whereas in 2003 they had risen sharply. The slowdown in 2004 is linked to the acceleration in productivity and was obtained despite the acceleration in the average cost of a full-time job.

The rise in average wages per job (FTE) rose during the year (see Table 2). This growth was close to that seen in 2002, but the context was slightly different. In 2004, the unemployment rate stabilised at a high level and, with the duration of work stable again, the rise in wages per job was the same as the rise in the hourly wage. In 2002, working hours had not yet totally stabilised and the unemployment rate was rising.

The acceleration in wage growth in 2004 took place at the level of workers paid the legal minimum wage. In both 2003 and 2004, workers paid the SMIC minimum benefited on 1 July from an additional «fillip» in amounts differing according to the level of the income guarantee and this rise was partially offset for firms by an extension of the reduction in social contributions in application of the arrangements for the harmonisation of the different versions of the SMIC provided for in the so-called Fillon Law (see «The French Economy 2003-2004). These arrangements, covering the three years 2003, 2004 and 2005, provided for a differentiated rise in the purchasing power of the minimum legal remuneration aimed at achieving a single hourly SMIC by 1 July 2005. In return, the partial indexation of the SMIC on the purchasing power of the hourly basic working wage was suspended, with no special »fillips". Applied at a time of very low wage growth, it created for a period of three years an upward ratchet effect on the purchasing power of the SMIC, which was then passed on into the bottom end of the wage scale. Given the acceleration in the year-on-year price rise excluding tobacco seen in May (to 2.1 % in 2004 from 1.6 % in 2003). The indexation clause and the purchasing power guarantee led to a sharp nominal upward adjustment in the legal minima : by an average of 4.4 %, compared with 3.9 % the previous year. The average cost of jobs paid at the stautory minima therefore accelerated by one half-point, after taking into account the extension of the arrangements for the reduction in social contributions.

The average rate of employers' social contributions increased further despite the build-up of the impact of the Fillon arrangements, with the overall impact of this increase on the cost of labour amounting to 0.1 % (see Table 2). This was because employers' contributions were raised by 0.3 of a point in July in return for an increase of one day in the time worked annually starting in 2005. In 2003, the rate had shown an overall increase despite the coming into force of the Fillon arrangements, because of measures taken to restore financial balance in the unemployment insurance system.

A slower rise in unemployment

The end of 2004 saw the number of unemployed on the ILO definition standing at 2,729,000 in Metropolitan France. The rise of 5 000 during the year was much smaller than that of 2003 (190,000). On an annual average basis, the unemployment rate came to 10.0 %, 0.3 of a point more than in 2003. Unemployment started to rise in the middle of 2001, just after the downturn in growth, because of the slowdown in employment.

Since 2000, demographic tendencies related to the ageing of the population have tended to curb the rise in the labour force[8.] In 2004 the rise was exceptionally small (24,000, compared with 100,000 in 2003). For one thing, early retirements from active work resulted in reduction of 71,000, due in particular to the implementation of the pension reform which led to the temporary accelerated retirement of persons having head a very long working life. Moreover, as in 2003, the depressed situation of the labour market continued to weigh down participation rates by prompting young people to continue their education and by bringing forward the retirement dates for older people.

It was younger people that were particularly affected by the rise in unemployment during the year, with the rate for the 15-24 age group reaching 22.8 % at the end of the year, a rise of 1.2 of a point. However, two-thirds of this age group are still in the educational system. Conversely, the unemployment rate for the over - 49 age group (7.2 % at the end of the year) showed a decline of 0.3 of a point during the year because of an acceleration in retirements from working life.

Prices : a deceptive acceleration

Just as in 2003, the consumer price index rose by an average of 2.1 % during the year, meaning that the rate stabilised following the low point reached in 2001 (1.7 %). The deflator for household consumption expenditure rose by 1.8 % in 2004, following 1.3 % in 2003. The acceleration in the consumption expenditure deflator at a time when inflation measured by the consumer price index remained stable is entirely due to the inclusion from now on in the scope of household consumption of financial intermediation services indirectly measured (FISIM) (see Box 1).

Box 1

Consumer price index and expenditure deflator : what is being measured ?

Quite apart from certain technical differences, the household consumer price index (CPI) and the household consumption expenditure deflator in the national accounts do not have exactly the same coverage. That of the CPI does not include imputed rents in the case of house-owners living in their own property, whereas these are included in consumer expenditure as recorded in the national accounts. Conversely, in the case of non-life insurance, the price index covers all premiums paid in, whereas payments of claims are deducted from consumption in the national accounts. Until the introduction of the 1995 base, these technical differences and differences in coverage had led to small differences between the respective evolutions.

With the introduction of the 2000 base, part of the «financial intermediation services indirectly measured» (FISIM), representing the margins taken by the banks on interest rates, is included in final consumption by households – To be more precise, it is counted as household FISIM, considered as consumption of banking services other than those related to their housing loans (see the special article on the 2000 base, to be published in due course). However, this FISIM does not fall within the coverage of the CPI. In recent years, the inclusion of FISIM in the coverage of consumption has had a significant influence on the evolution in prices :

- upward in 2000 ;
- downward in 1999, 2002 and 2003.

8. See Stéphane Lhermitte "Quel ralentissement de la population active attendre en 2004 ?", Insee - Note de conjoncture, décembre 2003 (available in French only).

Table 1
Three measures of inflation

% changes

Year	1999	2000	2001	2002	2003	2004
CPI	0.5	1.7	1.7	1.9	2.1	2.1
Consumption expenditure deflator	-0.6	2.3	1.7	1.1	1.3	1.8
Consumption expenditure deflator ex FISIM	0.3	1.4	1.5	1.7	2.0	2.0

In 2002 and 2003, the decline in interest rates led to a fall in the banks' margins on deposits and on savings products. With interest rates remaining stable at a low level, this phenomenon was not on the same scale in 2004 and this was reflected in an acceleration in the prices of consumer spending recorded in the national accounts.

The pattern over time in movements in the price index was dominated by energy and food prices and by the stabilisation of tobacco prices following the sharp rise at the end of 2003. The year-on-year rise touched a low of 1.7 % in March following the temporary stabilisation of energy prices during the winter, before peaking in June after a surge in food prices and again in August (2.3 % in both cases) because of the rise in energy prices and in prices of services other than those linked to housing, transport, communication and health.

The stability of the evolution in the overall index on an annual average basis is the resultant of stable core inflation (1.6 %) and a set of influences on the more volatile prices that tended to cancel each other out. For example, petroleum products and tobacco each contributed 0.2 of a point to the rise in the index, but food prices made a negative contribution of 0.3 of a point and health care services 0.15 of a point. The rise in international energy prices and the slower depreciation of the dollar meant that prices of petroleum products rose by 8.6 % in 2004 compared with 3.2 % in 2003 and contributed 0.4 of a point to inflation. On an annual average basis, tobacco prices rose by 24.6 % (as against 14.3 % in 2003) and contributed 0.5 of a point to inflation, as a result of a sharp increase at the end of 2003. On the other hand, prices of food products rose by only 0.6 % as against 2.2% in 2003; in particular, with weather conditions more favourable than the preceding year, prices of fresh produce declined by 4.4 %, having risen by 4.1 % in 2003. On similar lines, prices of health care services rose by only 0.8 %, the 3.7% rise in 2003 bearing the traces of the adjustment in official tariffs that took place in 2002.

The stability of core inflation, calculated excluding prices of public utilities and volatile products, is also the resultant of diverging evolutions. For example in the case of services other than those linked to housing, transport, communication and health care, where the prices paid by consumers mainly relate to the remuneration of employees or self-employed workers, inflation accelerated from 2.7 % in 2003 to 3.2 % in 2004. However the rise in prices of manufactures slowed down from what was already a very low rate (to 0.1 % from 0.3 %) and much the same was true of food products other than fresh produce (to 1.4 % from 2 %). Moreover, following the agreement on price cuts signed in June between the government and representatives of large-scale distribution[9], the end of the year saw a reduction in the prices of this sector in relation to those of other forms of retailing. However, since a move in the other direction had been seen in the early part of the year, the evolution on a year-on-year basis was very limited. Furthermore, the slowdown in prices of manufactures was helped by the decline in import prices due to the past appreciation of the euro and the resulting increase in low-priced imports.

Generally speaking, two events external to the French economy have influenced the evolution in prices during the past two years : the decline in the dollar since Q2 2002 had a downward influence on prices in 2003 and an even greater influence in 2004; in the other direction, the rise in the oil price pushed inflation up (see Table 1). In each of the two years, according to simulations that have been made, the disinflationary impact of the rise in the euro is estimated to have been more important than the inflationary impact of the rise in the oil price[10].

The productivity cycle stimulated the price fall in 2004 after holding it back in 2003. This was because firms adjust their workforces to turning points in demand only partially and after a time lag. In 2003, the slowdown in activity had led to an acceleration in unit costs ; in 2004 the acceleration in activity encouraged a slowdown.

Upturn in households' real income

In 2004, gross household disposable income rose by 3.2 %. Given that consumer expenditure prices rose by 1.8 %, this meant an increase in purchasing power of 1.4 %. In 2003, there had been relatively little growth in real household income (0.4 %).

Between 1998 and 2002, the purchasing power of gross household disposable income had risen each year by a little over 3 %. This meant that the slowdown in growth seen since 2001 was reflected in household income only in 2003. In 2002, income growth had admittedly slowed down, but this had been offset by tax cuts (- 0.4 %) and the strength of the social benefits, while financial income was still rising slightly[11].

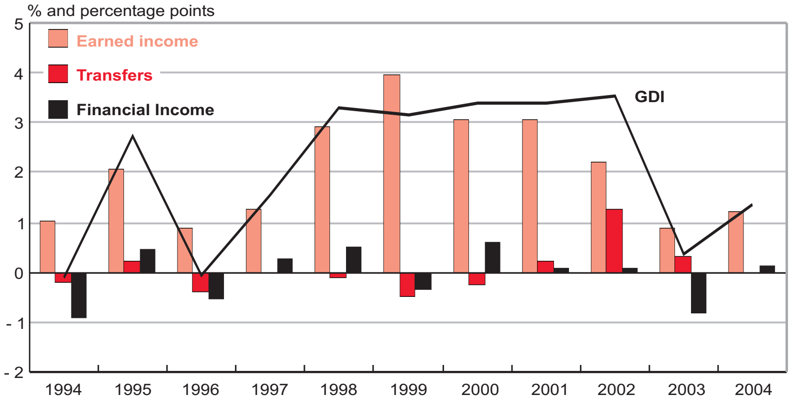
The evolution of income in 2003 (+ 0.4 %) therefore marked a substantial break with previous tendencies. What happened was that wage income receipts slowed down sharply and financial income had declined markedly. As regards compulsory levies, the growth in taxes was resumed (+ 3.3 %). However, the self-employed had benefited from price rises in the agriculture and building sectors and from growth in activity in healthcare, while property-owners enjoyed an acceleration in rents.

In 2004, the rise in household purchasing power was resumed. The contribution of earned income to the purchasing power of disposable income increased as a result of the rise in the total wage bill. Despite the stagnation of employment, there was an acceleration in wages and salaries received (+ 2.8 %), with a slowdown in wages and salaries re-

9. These agreements provided for price cuts of 2 % on everyday consumer goods, in other words certain manufactures (cleaning products, cosmetics) and food products other than fresh produce.
10. Numeric estimates : according to the MZE model, the disinflationary impact of the appreciation of the euro was - 1 point in 2003 and - 2,6 points in 2004 ; according to he Mésange model, the inflationary impact of the rise in the oil price was + 0,6 of a point in 2003 and + 1 point in 2004.
11. In the 2000 base, financial income includes final consumption of FISIM.

Graph 8

Contributions to the evolution in the purchasing power of gross household disposable income



Source : Insee, national accounts- 2000 base.

How to read the graph : This graph breaks down the purchasing power of gross disposable household income into its principal components : earned income (gross wages and salaries and cash flow of the self-employed and pure households; net financial income (interest and dividends) ; and the balance between social and tax contributions (mainly taxes and social contributions) and transfers received (social benefits in cash). This means that the 1.4% rise in the purchasing power of GDI in 2004 is explained as follows : 1.2 of a point is due to the rise in total earned income, while the contribution of net investment income is 0.2 of a point (0.15) and that of the balance on transfers is for all purposes nil.

ceived from government to a small extent offsetting the acceleration in receipts from firms. But growth in the cash flow of the self-employed accelerated (to 3.4 % from 2.6 %) despite the ending of pressures on agricultural prices and the slowdown in income related to healthcare; that of households also accelerated (to 5.6 % from 4.4 %) because of the sharp rise in actual and imputed rents[12.] At the same time, with firms showing themselves more generous as regards dividends, net financial income again increased.

Tax payments and transfers made no contribution to the evolution in purchasing power

Taxes and actual social contributions payable by households, excluding employers' social contributions, which had accelerated in 2003 (+ 3.7 %) slowed down in 2004 (+ 2.8 %), the result being favourable to income. Meanwhile, benefits received in cash continued to rise (+ 4.0 % following + 4.2%). But the net balance of other current transfers in favour of households, which had risen by € 0.4 million in 2003, fell by € 4.1 billion in 2004, reducing nominal income by 0.4 %. Finally, the net balance on taxes and transfers (€ 87.8 billion in favour of households) rose by 1.8 % and made no significant contribution to the purchasing power of disposable income.

The totality of taxes on income and wealth paid by households slowed down distinctly (+ 2.4 % following + 3.3 % in 2003). While personal income tax declined (by 0.9 %) because of the slackness of income growth in 2003 and a further easing of tax rate

12. In the national accounts, the imputed rent that house-owning households would receive if they were to rent out the property they live in is included both as income and as own-account consumption.

schedules, local taxes paid by households rose strongly (+ 5.5 %). Taken together, the impact of the newly-applied measures increased compulsory payments by households by € 0.5 billion in 2004 following an easing of a € 0.8 billion in 2003.

Despite the slowdown in healthcare expenditure and the small rise in unemployment benefits (+ 2.4 %), social benefits in cash barely slowed down. Expenditure was in fact increased by the gradual build-up of two new measures : "Prestation Accueil du Jeune Enfant " (Arrival of Infant Allowance) and the reform of the pension system. Following the pension reform carried out in 2003 (see the special article "Le marché du travail après 50 ans", available in French only) the pension systems have borne the cost of the increasing number of claims to early retirement by people with long working lives.

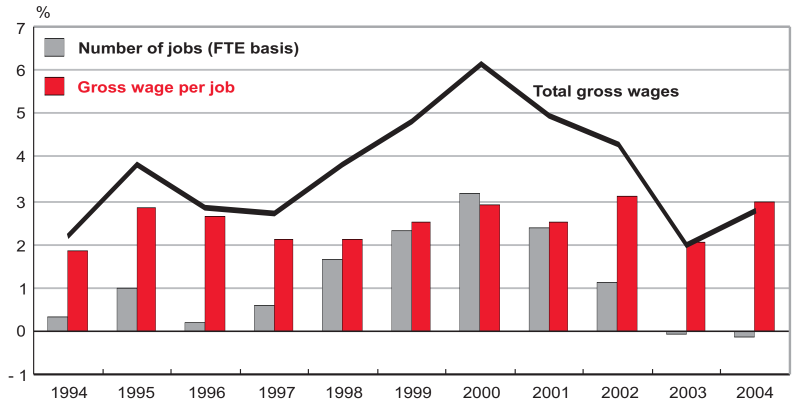
Resumption of the rise in earnings

In 2004, growth in total gross wages and salaries accelerated (+ 2.8 %, compared with + 2.0 % in 2003). There was an erosion of dependent employment but gross average remuneration per full-time job accelerated (+ 3.0 % compared with + 2.0%).

In the case of general government, which pays out one quarter of total wages and salaries, gross wage and salary payments slowed down (+ 2.9 % compared with + 3.4 % 2003), because of the downturn in employment growth (- 0.3 % compared with + 0.9 %), while average wages per head accelerated. However, the overall impact of the general measures was limited to 0.5 % (compared with 0.8 % in 2003). The decline in employment to a great extent involved assisted jobs, paid much less than the average wage, meaning that the impact of the fall in employment on total wages and salaries was smaller than the fall in employment itself. In practice, the rise in total wages and salaries was particularly marked in the case of local authorities and hospitals.

In the other institutional sectors, total gross wage and salary payments accelerated distinctly (+ 2.8 % compared with + 1.7 % in 2003), despite the fact that employment barely declined (- 0.1% compared with - 0.4 %) and gross wages per head accelerated.

Graph 9
Evolutions in total wages and salaries, wages per job and number of jobs



Source : Insee, National accounts - 2000 base

A further fall in the saving ratio

In 2004, consumption in volume rose more rapidly (+ 2 %) than purchasing power. The saving ratio fell for the second consecutive year, to 15.4 % from 16.0 % in 2003 and 16.9 % in 2002.

The fall in the saving ratio in 2003 had reflected households' usual behaviour of adjusting the evolution in their spending to that of their income but smoothing the adjustment over time, the result being a decline in the saving ratio in times of low income growth. In fact, despite the low growth in their real incomes, households had continued to increase their consumption expenditure at the same rate as in 2002 (+ 1.4 % in volume).

In 2004, the decline in the saving ratio took place despite the recovery in income growth. Although accelerating, income growth in 2004 remained well below what it had been from 1998 to 2002. Considerations other than the evolution in incomes also influence saving behaviour. In 2004, the persistence of a high unemployment rate may have prompted households to build up precautionary savings, but the historically low level of interest rates probably had a dissuasive influence on saving and provided an incentive for consumption. Moreover, during the year the government took a whole set of measures aimed at encouraging consumption :

- a measure encouraging family gifts inter vivos in favour of the younger generations,
- a measure permitting the utilisation of the sums accumulated in wage-related savings schemes
- a measure introducing a tax credit on the interest paid on consumer loans.

The effect of all these various measures was to encourage spending without modifying income (see «Conjoncture in France» for March 2005).

From a low point in 2000 (15.1 %)[13,] the saving ratio had risen sharply in the two following years, reaching 16.9 % in 2002. This movement can be interpreted as a return to more usual saving behaviour after an exceptional period. The saving ratio in 2000 was historically low, having been reached after three years' decline despite rapid income growth. Factors liable to explain this evolution include the decline in unemployment, the stock-market euphoria, the upturn in house prices and a favourable tendency in interest rates. In what was perhaps an overconfident climate, the bursting of the technology bubble may have led to greater awareness of financial risks and stimulated a precautionary reflex. The downturn on the labour market in 2001 seems to have completed the process by prompting households to build up precautionary savings in the short term in order to face up to the risk of unemployment.

However, it is also possible that the shift to the euro at the beginning of 2002 may have intensified the saving behaviour. It seems that in France, as in all other euro-zone countries, the move meant that consumers entirely lost their bearings as regards prices. In 2003, surveys continued to indicate that perceived inflation exceeded inflation as measured by the INSEE price index by several points.

13. The picture of evolutions in the saving ratio has been substantially changed as result of the move to the 2000 base.

Expenditure paid by government bodies continuing to underpin effective consumption, despite slowing down

Expenditure in favour of households and financed out of general government funds, the so-called «individualisable» publicly-financed expenditure, rose by 4.1 % in value and by 2.2 % in volume (compared with 5.4 % and 2.9 % in 2003). In addition to various types of aid, this spending comprises spending on healthcare and education. In 2002, it showed a rapid rise (+ 7.3 % in value and + 4.3 % in volume) because of the sharp increase in healthcare expenditure. In 2004, the slowdown in healthcare spending was the main cause of the slowdown in this type of expenditure as a whole. However, despite slowing for the second consecutive year, the «individualisable» expenditure rose slightly faster than spending financed by households themselves and as a result tended to support their effective consumption.

Finally, the «household effective consumption» aggregate, which brings together all expenditure from which households benefit individually, whether financed by themselves, in the form of non-charged benefits or of repayments, picked up slightly (+ 2.1 % in 2004, + 1.8 % in 2003 and + 2.6 % in 2002). Its contribution to GDP growth was 1.4 of a point.

Fall in the public deficit but rise in the debt

In 2004, the upturn in growth led to an increase in the compulsory contribution ratio and an improvement in public balances, given the absence of an overall acceleration in expenditure.

Public expenditure rose more slowly (+ 3.6 %) than GDP in value and its share of GDP fell from 53.7 to 53.3 %. For the second consecutive year, growth in spending (+ 5.6 % in 2002) slowed down; this slowdown involved, in particular, wages and salaries (+ 2.9 % following + 3.4 %) and also benefits and other social transfers in kind (+ 4.0 % following + 5.0 %), which constitute the largest items. This slowdown restricted the acceleration in household incomes. It also involved general government GFCF (+ 5.8 % following + 9.5 %).

The compulsory contribution ratio rose by 0.3 of a point to 43.4 %. As the economic upturn was to a large extent driven by domestic demand, indirect tax revenue grew particularly strongly, as did corporation tax. However, there was only a small spontaneous increase in social contributions, given the weakness of the rise in total wages and salaries. The overall impact of the tax- and social-security-related measures introduced in 2004 was to increase the compulsory contributions as a proportion of GDP by 0.1 of a point. Overall, compulsory contributions rose slightly faster than GDP in value (+ 4.8 % compared with + 4.0%).

Finally, there was a moderate improvement in the public balances. The public deficit as defined in the Maastricht Treaty amounted to 3.6 % of GDP, down from 4.2 % in 2002. The general government financing requirement came out at € 60.1 billion, € 5.4 billion less than the previous year. The central government financing requirement, forming the bulk of the total, fell sharply to € 40.3 billion from € 57.3 billion in 2003. However, there was a further increase in the financing requirements of social security organs and local authorities.

Public debt as defined in the Maastricht Treaty rose from 62.8 % of GDP at end-2003 to 64.7 % at end-2004, equal to the EU average but below the average for the euro zone (71.3 %) ❑

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