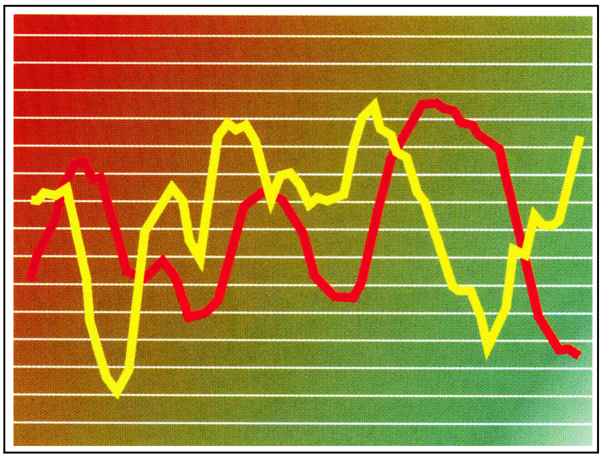
CONJONCTURE IN FRANCE

DECEMBER 2006



FRENCH GROWTH: COPING WITH THE INTERNATIONAL SLOWDOWN

INSEE

CONJONCTURE IN FRANCE

DECEMBER 2006

FRENCH GROWTH:
COPING WITH THE INTERNATIONAL SLOWDOWN

FRENCH GROWTH: COPING WITH THE INTERNATIONAL SLOWDOWN

After rebounding by 0.9% in Q4 2006, the French economy is expected to grow at a moderate pace of about 0.5% per quarter in early 2007, notably because of a less vibrant international environment.

The world economy is experiencing several adverse developments. The U.S. economy, buffeted by the plunge in the real-estate market, is losing momentum. Japan's exit from deflation is stalled. Investment is slowing in Asia—particularly in China, where the government's cooling-off measures seem to be finally effective. In the euro zone, the tighter policy mix—including Germany's VAT increase on January 1, 2007—should weigh on household demand at the start of the new year.

The world economy can, however, count on two positive developments. Oil prices have receded sharply since their August 2006 peak, bolstering real personal income and improving corporate financial health. The euro zone, which posted surprisingly brisk growth in 2006, can rely on firmer domestic demand, fueled by robust business investment.

While these positive forces will likely moderate the global economic slowdown in H1 2007, they will not prevent it altogether.

Amid this loss of international momentum, French growth should prove resilient. First, a sharp rebound is likely in Q4 2006 (0.9% after 0.0% in Q3), in particular thanks to a correction of the largely accidental economic contraction in Q3. In fact, this is what the latest business surveys point to.

Next, the French export slowdown should, once again, be offset by the relative vigor of domestic demand, especially household consumption. Disinflation and income-tax cuts should combine with a fresh rise in earned income to produce solid gains in real household income. As a result, growth should weaken less in France than in the rest of the euro zone in early 2007, staying close to its average pace since summer 2005.

The French economy is thus expected to keep creating jobs. Given the sharp slowdown in the growth of the active population since the early 2000s, this should lead to a further decline in unemployment to 8.2% by June 2007.

The main uncertainty surrounding these forecasts concerns the size of the U.S. real-estate market adjustment and its contagion effects on the rest of the U.S. economy and—more widely—the world economy. The second uncertainty is how German and French households will react to tax changes in early 2007. If consumers adjust their consumption behavior to their new incomes immediately, this will accentuate the purchasing downturn in Germany and the purchasing upturn in France. If, instead, they base their consumption decisions on their long-term income growth, the consumption swings will be dampened.

On the currency front, after many months of exchange-rate stability, the dollar's weakness in late November and early December signals a resurgent risk of further slippage by the U.S. unit. ■

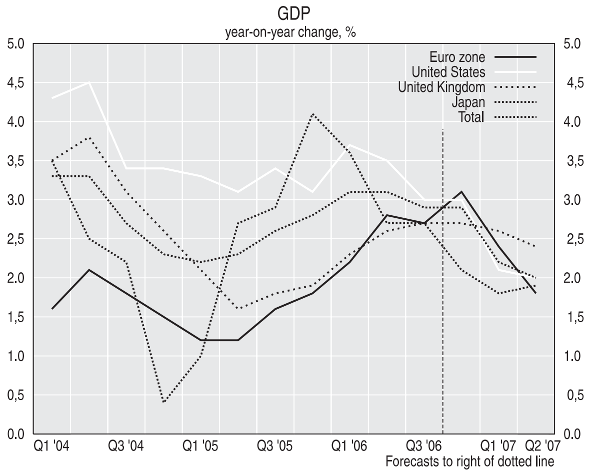
Despite sharp fluctuations in spring and summer 2006, the French economy has been driven since summer 2005 by fairly steady growth in final domestic demand of about 0.6-0.7% per quarter. In the coming quarters, however, the country's economic performance may become more dependent on an international climate less buoyant than in 2006.

U.S. slowdown and German VAT shock: France faces a deteriorating international environment

A trend shift is under way in the world economy. After four years of exceptional growth in both production and trade, this summer brought signs of weakening momentum. A global slowdown is now perceptible, in the wake of U.S. economic developments and as a result of the widespread monetary tightening measures enacted for over a year. Economic activity is projected to slow in the main industrialized areas simultaneously, reducing their combined growth to an annual 2% by mid-2007 after nearly 3% in 2006 *(Chart 1)*.

The slowdown should, however, remain limited, especially because U.S. growth is unlikely to register an abrupt downswing. The U.S. economy is exposed to conflicting forces, and it is not easy to determine which will prevail. On the negative side, the real-estate market correction is inhibiting residential investment and may eventually impact employment and consumption. On the positive side, the fall in energy prices is boosting the incomes of households and businesses—and consequently their expenditures. By next spring, the positive forces should very gradually prevail. The real-estate market should slowly normalize, without significant contagion on household consumption. The end-2006 decline in energy prices and the continued vigor of wage and salary earnings should provide impetus to consumption. Meanwhile, the return of economic growth below its potential and the recent inflation easing could lead the Federal Reserve to lower its key rates by spring 2007. Under this scenario, U.S. growth, which stayed above 3% in 2006 (at 3.3%), is forecast to dip to an annualized 2% or so in early 2007, with a statistical overhang of 1.6% at the end of Q2 2007.

1



The softer U.S. economy should affect world trade growth, which will gradually decline as a result of other factors. Emerging Asian countries will continue to restrain investment, in the knowledge that

FRANCE: GROSS DOMESTIC PRODUCT (volume) BY TYPE OF EXPENDITURE

(at 2000 prices, seasonally and working-day adjusted data, % change from previous period)

		2005				2006				2007		2005	2006	2007 ovhg*
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
GDP	(100%)	0.1	-0.1	0.8	0.2	0.5	1.2	-0.0	0.9	0.5	0.5	1.2	2.1	1.8
Imports	(28%)	1.0	1.1	2.7	2.8	1.2	2.8	0.0	1.7	1.2	1.2	6.4	7.7	4.1
Consumption	(54%)	0.5	-0.0	0.9	0.5	0.9	0.7	0.6	0.7	0.7	0.7	2.2	2.8	2.2
Public consumption**	(24%)	0.1	-0.0	0.7	0.1	0.6	0.6	0.3	0.5	0.4	0.4	0.9	1.7	1.4
Investment	(19%)	0.9	0.5	1.8	1.0	0.1	1.6	0.5	1.4	0.5	0.6	3.7	3.7	2.6
of which:														
Non financial corporated and unincorporated enterprises	(11%)	0.6	0.0	2.4	1.1	-0.4	2.2	0.8	2.0	0.6	0.6	3.8	4.2	3.5
Households	*(5%)*	0.6	0.0	2.4	1.1	-0.4	2.2	0.8	2.0	0.6	0.6	3.8	4.2	3.5
Exports	(29%)	-0.5	0.4	3.4	0.7	2.9	1.1	-0.7	1.5	0.8	0.8	3.3	6.2	2.5
Contributions to growth														
Internal demand ex. inventory changes		0.5	0.1	1.0	0.5	0.7	0.9	0.5	0.8	0.6	0.6	2.2	2.8	2.1
Inventory changes***		0.1	0.0	-0.4	0.3	-0.7	0.9	-0.3	0.1	0.0	0.0	-0.0	-0.1	0.2
Net foreign trade		-0.4	-0.2	0.2	-0.7	0.5	-0.6	-0.2	-0.1	-0.1	-0.1	-0.9	-0.5	-0.6

Forecast - Weight in 2000 in brackets

* 0vhg: statistical overhang, i.e. annual change if variable in question was to remain at its level in the last known quarter. The overhang measures the impact of past changes; it is not a forecast.

** General government and NPISH's consumption expenditures

***Inventory changes include acquisitions net of sales of valuable

INSEE

China—because of its deliberate efforts to curb growth—would experience a manufacturing activity slowdown. After an unusually brisk performance in early 2006, Japan, too, is set to undergo a relatively sharp slowdown. Besides the world-trade deceleration, the Japanese economy will probably see an adjustment in corporate investment, which—in view of weaker lending in recent months—will last for some time. The United Kingdom promises to be the most resilient of the industrialized economies.

In the euro zone, two further dampening factors will compound the effects of the global trade slowdown. The first is an external factor: the appreciation of the euro's effective exchange rate (by convention, we have set the euro at $1.30 in our forecast). The second is an internal factor: the tightening of the policy mix, with a return to neutrality for European short-term rates and the fiscal adjustments in Germany and Italy. The increase in Germany's standard VAT rate will substantially impact consumer prices, will weigh heavily on German household expenditures, and, more generally, will lower euro-zone growth. Admittedly, the German recovery has been firming steadily since early 2006, and the combined surge in exports and business investment should lift German GDP growth to an annual 2.7% this year. At the close of 2006, household purchases ahead of the VAT rise should give a temporary but significant boost to demand despite persistently weak gains in wages and salaries. In early 2007, the negative shock on household consumption due to the indirect-tax hike should therefore result in near-zero growth in Q1. However, this should not cause lasting damage to the German recovery, as the latter is largely fueled by brisk exports, the end of the long and painful structural adjustment in the construction industry, and the strong need for equipment investment.

In the euro zone as a whole, the German shock will disrupt GDP growth in the months ahead. After a relatively lackluster Q3 2006, a rebound is expected in Q4, largely thanks to the catch-up in France and advance purchases by German households. Annual GDP growth for 2006 is thus forecast to reach 2.7%, the highest figure since 2000, but this will be followed by a slowdown throughout the euro-zone in 2007. All countries will probably suffer from the slacker rise in foreign demand outside the zone and, directly or indirectly, from the temporary decline in German consumer spending. Moreover, Italy's economic expansion will be hampered by persistent competitiveness problems and the planned fiscal and tax tightening. Euro-zone GDP is projected to gain 0.2% in Q1 2007 and 0.4% in Q2.

This loss of global buoyancy will, however, have a favorable consequence that should attenuate the economic slowdown: among other effects, the downturn in total demand in the commodity markets will probably allow oil prices to stabilize at around $60/barrel. This would promote further easing of inflation in most regions.

French exports are forecast to decelerate, causing industrial production to grow more slowly at the start of 2007

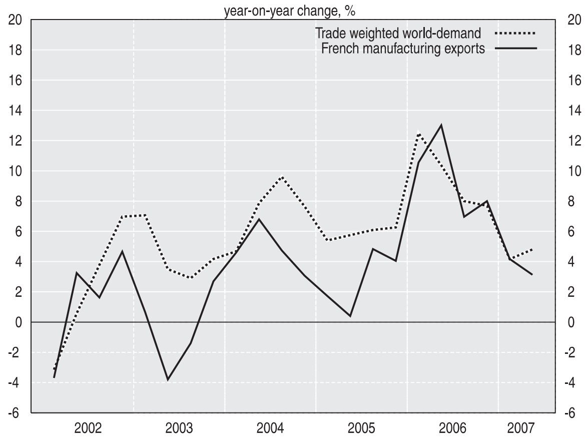
The external trade and industrial production have displayed particularly jagged profiles this year.

Export statistics were skewed by atypical flows of mobile-telephony products, which inflated exports (and imports) in H1; conversely, this phenomenon depressed exports in Q3, which also saw below-normal Airbus deliveries. Quarterly changes should therefore be interpreted with caution. While international order books have been shrinking since the summer because of the gradual deterioration in the global economic climate, they have stayed high at year-end 2006. This, combined with a return to normal for Airbus deliveries, suggests a likely rebound of manufactured exports in Q4. For 2006 as a whole, manufactured exports are estimated to have jumped 9.6%, a pace just below trade-weighted foreign demand (up 10.2%) *(Chart 2)*. This result owes much to the German economy's new-found strength. In early 2007, however, the pace of export growth is forecast to ease to a quarterly 1.0%, consistently with the slippage in foreign demand.

The sharp swings in manufacturing output—up 2.1% in Q2, down 1.8% in Q3—no doubt reflect several phenomena. They are partly due to problems in specific sectors, particularly the automotive industry, which has been cutting back production on an ad-hoc basis *(see "Vers une nouvelle donne sur le marché mondial de l'automobile?" [Toward a reshaping of the world automobile market?] box, available in French version only)*, and to standard fluctuations in other sectors (notably aeronautics), which seem to be unusually wide this year. It seems wiser to interpret current changes in manufacturing output on a smoothed basis. The 12-month change in the aggregate improved from a negative 1.2% at end-2005 to a positive 0.7% at the end of Q3, effectively reflecting

2

EXPORTS IN LINE WITH WORLD DEMAND



the export acceleration. The business survey in industry, while failing to signal the Q3 drop in manufacturing output, had hinted at a loss of momentum in the sector. The November survey results are consistent with a brisk production rebound in Q4 (1.3% in our forecast). In the quarters ahead, the year-on-year change in manufacturing output is expected to return to a milder pace, reaching 0.3% by mid-2007.

Meanwhile, manufactured imports continue to grow very briskly, putting the expected annual average rate at 10.4%. The rise in imports is still driven by growth-unfriendly price movements and by the vigor of household consumption in categories such as consumer goods and automobiles.

The steady fall in unemployment is set to continue until mid-2007

The consequences of the economic upturn in 2006 are visible in the labor market. The addition of 243,000 jobs in the total French economy this year appears to be largely due to growth in the market sectors. Another contributing factor is the sharp rise in non-market sectors, particularly via subsidized employment programs.

After a year of moderate recovery in 2005 (77,000 new jobs), market-sector payroll employment is gaining strength. Buoyed by a more robust economy, non-farm market sectors will probably have created 138,000 jobs in 2006, followed by 73,000 in H1 2007. Manufacturing industries are destroying fewer jobs, while the construction industry is expected to keep hiring at a brisk pace and the tertiary market sector appears to be expanding its workforce steadily. By contrast, the data point to a dip in subsidized employment at the start of 2007.

With the active population growing more slowly than in the first half of the decade, the positive trend in market and non-market components of employment ought to provide continued momentum for the steady decline in the unemployment rate, which should reach 8.6% at end-2006 and 8.2% at end-June 2007.

Real household income is accelerating thanks to disinflation and income-tax cuts

The stabilization and incipient downturn of energy prices have had rapid effects on French inflation. Price growth fell to 1.1% in October 2006 and should reflect energy disinflation in the months ahead. Inflation is accordingly expected to reach 1.4% in December and 0.8% in June 2007, with core inflation fluctuating around 1.5% in the same period.

This inflation easing is playing a major role in the profile of households' total real gross disposable income. After gaining 1.3% in 2005, gross disposable income will have grown by an estimated 2.4% in 2006, producing a statistical overhang of 2.5% by mid-2007.

Besides disinflation, three other key factors are contributing to this positive trend: in 2006, the stronger momentum in gross wages and salaries (up 4.0% in 2006 after 3.2% in 2005 in the private sector) and the swelling income of unincorporated enterprises; in 2007, the slowdown in income-tax and asset-tax receipts. The latter is a consequence of changes in income-tax brackets and the implementation of a "tax shield" (*bouclier fiscal*, a cap on direct, local, and wealth taxes).

A stimulus to household consumption

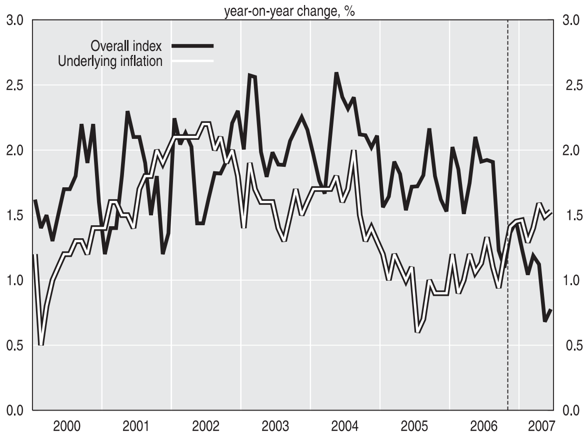
Robust household spending is unlikely to flag in the quarters ahead.

Household expenditures on manufactured products are expected to grow by about 0.9% per quarter, a slightly milder pace than the one observed in the last three quarters. By contrast, after an unusually slack Q3, expenditures on services are poised to rebound. Overall, household consumption is on track to 0.7% quarterly growth until mid-2007, in line with the rise in real household income. Meanwhile, residential investment, after a pause in Q4 2006, should return to a growth path in early 2007, gaining 0.3-0.4% per quarter.

This positive household-demand trend should be compounded by the still-steady increase in individual government expenditures.

3

FRENCH CONSUMER PRICES



Forecasts to right of dotted line

The international climate should make firms cautious in their investment outlook

After gaining 4.1% in 2004 and 3.8% in 2005, business investment is likely to grow by 4.2% in 2006, including an expected 2.0% rebound in Q4. At present, these figures fail to indicate a standard recovery-phase acceleration. Nevertheless, the investment rate is set to reach a historically high 18.5%.

Looking ahead, despite the margin ratio's stabilization over the past year, shakier economic prospects may lead business leaders to adopt a more cautious attitude in their investment expenditures, which should grow by a quarterly 0.6% in early 2007. Their uncertainties may be summed up as follows: True, household demand is solid, but foreign demand is weakening and its future depends on how the U.S. and German economies respond next year. True, commodity prices are easing, but the euro's appreciation amid monetary tightening fuels concerns over the return on investment.

After a brisk rebound in all industries at year-end, wholesale/retail trade and market services are poised to be the main drivers of GDP growth in early 2007

In addition to the jumpy profile of industrial production, the negative performance of total production in Q3 is due to a combination of several one-time factors.

Market services also experienced a sharp slowdown for two reasons: first, slacker demand from businesses, an indirect consequence of the shock in manufacturing; second, an atypical decline in household consumption of recreational, cultural, and sports activities as well as of hotel and restaurant services.

In Q4 2006, activity in all sectors is set to rebound at the same average rate as GDP, i.e., 0.9%. Industrial production should pick up. Market services should once again be driven by corporate and household demand. The wholesale/retail sector is poised to regain momentum in Q4 with the revival of final demand. The construction industry should benefit from an upward adjustment of civil-engineering production.

In early 2007, wholesaling/retailing and market services—stimulated by domestic demand—will drive growth in total production, whereas industrial production will slacken again. Wholesaling/retailing should experience a very mild slowdown in H1 2007 but, in step with consumption, it is forecast to gain 0.7% per quarter. Market services are expected to match household-expenditure growth as well, moving up 0.6% per quarter. The construction industry, while less buoyant than in 2006, should nevertheless remain on a positive track.

To sum up, total production is forecast to grow 0.5% per quarter in H1 2007, like GDP, and the statistical overhang for GDP growth is set to reach 1.8% by mid-year. ■