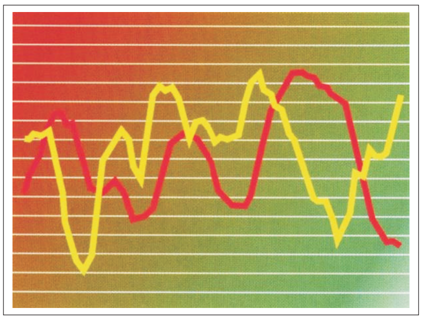
INSEE CONJONCTURE

CONJONCTURE IN FRANCE

DECEMBER 2004



A BUMPY RECOVERY

INSEE

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In Europe, the recovery that began in mid-2003 tended to mark time in Q3 2004, under the impact of a downturn in exports. Growth was already weak because of continuing slack domestic demand, although in this respect France was an exception, because of brisk household consumption. The temporary decline in this item, together with certain one-off factors, intensified the slowdown in activity in Q3. Since the end of the vacation period, business surveys in Europe have provided reassurance that the upturn phase has not in fact been called into question. In France, industrial output is rising again and consumption is looking healthier. As a result, following the partly accidental pause this summer, GDP could increase by 0.6% in Q4, bringing growth for 2004 as a whole to 2.1% (figures adjusted for the number of working days[(1)]), the best performance since 2000. Consumption is thought to have risen by 2.1% in 2004, slightly faster than purchasing power (1.6%) despite an environment prompting households to exercise caution, with job creations picking up slightly (35,000 in the market sector) and a very gradual decline in the unemployment rate, largely due to withdrawals from the active labour force. The recovery in investment is likely to remain moderate (2.8%), while on a national accounts basis the contribution from foreign trade would be negative, in particular because of exceptionally vigorous imports.

The first half of 2005 is likely to see a slowdown in the euro zone's international environment. Growth in the United States, which has remained brisk in Q4 2004 (of the order of 4%), is likely to return to annualised rates of around 3%, with the ending of the fiscal stimulus and the gradual tightening of monetary policy. This latter factor would also be the reason for a slowdown in United Kingdom growth.

In the euro zone, interest rates are likely to remain low and continue to encourage domestic demand. But the rise in the euro versus the dollar, quite apart from its direct impact on competitiveness, is restraining business leaders' expectations. The prudent attitude they have adopted towards wages is preventing the past rises in oil and raw material prices from triggering an inflationary spiral but at the same time curbing purchasing power and hence domestic demand. In these circumstances, growth in the euro zone in H1 2005 is likely to be at a rate slightly below its long-term average. France would post an annualised rate of a little less than 2%, like household consumption. The latter would have the benefit of the purchasing power gains provided by a slight tendency to disinflation (1.7% in June 2005 compared with 2.1% in December 2004), while at the same time dependent employment would continue to grow modestly (25,000 jobs created in the first half) and the unemployment rate would improve very slowly (to 9.7% in June 2005 from 9.9% in October 2004).

In the short term, the unknown factor most likely to affect French growth lies in the evolution of the dollar, for which the structural factors operating in favour of depreciation are well entrenched. The oil price may also play a role, but its direction is difficult to predict: the diminution in speculative behaviour and allowance for the prospect of a slowdown in demand may tend to weaken prices, but a severe winter in the United States or a revival of tension in the Middle East would have the reverse effect. ■

(1) In 2004, the impact of the number of working days is estimated to be between 0.2 and 0.3 of a GDP point.

After benefiting only to a small extent from the earlier acceleration, French exports are now confronted with a weakening of world trade combined with an appreciation in the single currency

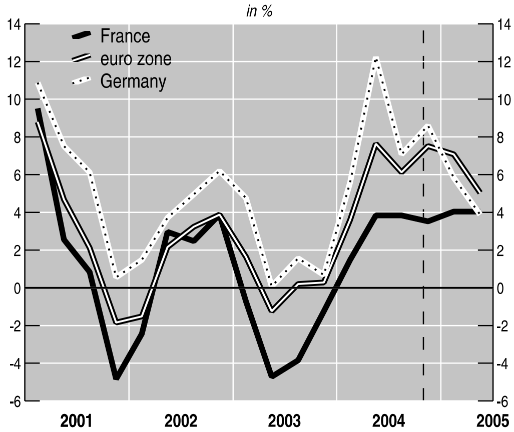
The intensification of world trade that began in mid-2003 was mainly fuelled by the regained dynamism seen in the euro-zone's main trading partners, especially Asia and the English-speaking countries. Exports from the euro zone then automatically benefited from this improvement, so that, at a time when domestic demand was spinning its wheels, the zone returned to quarterly growth rates of 0.5%, a quarter of this being due to the balance on external trade. France remained a laggard in this respect, with exports growing only one third as fast as German exports. Even so, while the French economy does not seem to have benefited as much as the other euro-zone countries from this more supportive international environment, this is partly because domestic demand in Germany, France's main trading partner, was particularly weak.

It is unlikely that French export performance will have the possibility of improving in coming months, because the support from the outside world is gradually tending to fade. Already in Q3 2004, the first signs of a slowdown in world trade had an abrupt negative impact on exports of manufactures from all the euro-zone countries. This levelling off in demand for the euro zone's goods is likely to be confirmed through into 2005 as a result of the weaker growth posted in its principal trading partners. In particular, domestic demand in the United States and the United Kingdom is set to slow down gradually.

1

FRANCE - EURO ZONE - GERMANY: MERCHANDISE EXPORTS

in %



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In both these countries, the slowdown in employment growth and the first effects of monetary tightening are liable to induce household consumption to mark time in the early part of 2005. In addition, firms are likely to adopt a more prudent investment policy, in line with the deterioration in the demand outlook. In the case of the United States, this means that growth, after being still lively in Q4 2004 (around 4%), would fall back to annualised rates of around 3%. In the United Kingdom, growth in activity, having reached an annual average of 3.2% in 2004, would fall back at the beginning of 2005 to 0.6% per quarter.

For European exporters, the reduction in the support provided by external demand will be all the more felt in that they have since Q3 2004 been confronted with the steep fall in the dollar. Even on the conven-

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

(at 1995 prices seasonally and working-day adjusted data, % change from previous period)

		2003				2004				2005		2003	2004	2005*
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
GDP	(100%)	**0.2**	**-0.5**	**1.0**	**0.6**	**0.7**	**0.6**	**0.1**	**0.6**	**0.5**	**0.4**	**0.6**	**2.1**	**1.4**
Imports	(27%)	-0.3	-0.5	-0.2	3.0	1.1	3.9	2.5	0.8	1.0	1.1	0.2	7.7	4.7
Consumption	(54%)	0.7	-0.3	0.9	0.4	1.0	0.5	-0.1	0.6	0.4	0.4	1.7	2.1	1.2
Public consumption	(23%)	0.3	0.2	0.9	0.8	0.4	0.9	0.3	0.7	0.4	0.5	2.5	2.5	1.7
Investment	(20%)	0.0	0.2	1.0	1.5	0.1	1.3	-0.5	0.9	0.9	0.7	0.2	2.7	2.2
of which:														
Non financial corporated and unincorporated enterprises	(12%)	*-0.8*	*0.0*	*1.4*	*1.9*	*-0.1*	*1.3*	*-1.0*	*1.2*	*0.9*	*0.6*	*-1.6*	*2.8*	*2.1*
Households	*(5%)*	*0.2*	*0.2*	*-0.1*	*0.5*	*0.8*	*2.2*	*0.7*	*0.9*	*1.4*	*1.1*	*0.8*	*3.4*	*3.8*
Exports	(29%)	-2.2	-1.3	0.8	1.5	0.5	0.9	0.8	1.2	1.0	0.9	-2.6	3.2	3.3
Contributions to growth														
Internal demand ex. inventory changes		0.4	-0.1	0.9	0.7	0.6	0.7	-0.1	0.7	0.5	0.5	1.6	2.3	1.5
Inventory changes		0.3	-0.2	-0.2	0.3	0.2	0.7	0.7	-0.2	0.0	0.0	-0.2	1.1	0.3
Net foreign trade		-0.6	-0.2	0.3	-0.4	-0.2	-0.8	-0.5	0.1	0.0	-0.1	-0.8	-1.2	-0.4

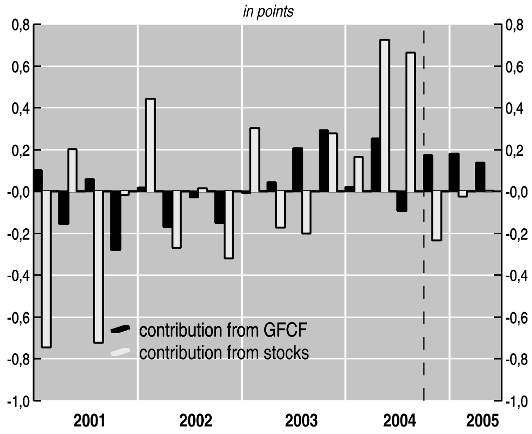
Forecast

* Carry over effect at Q2.

2

FRANCE: CONTRIBUTION OF THE COMPONENTS OF CORPORATE DEMAND TO GDP

in points



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tional assumption of unchanged exchange rates (at 1.30 in the case of the euro/dollar rate), all the single-currency countries would find themselves losing competitiveness around the turn of the year, and these losses alone would reduce annual growth in the euro zone by around 0.1 of a point. Moreover, with the dollar falling back against most other currencies, activity in the other trading partners of the United States would also be handicapped, leading in the final analysis to a substantial decline in world demand for euro-zone exports.

In France, the end of 2004 and the early part of 2005 should see firms normalising their demand by cutting growth in productive investment

Looking back, therefore, Q3 2004 seems to have been a turning point for activity in the euro zone. In Germany, exports, which had previously been lively, declined steeply, while in France domestic demand excluding stocks, which had been the main driving force for growth for the past year, stagnated so that, at a time of soaring oil prices, growth was brought to an abrupt halt. Admittedly, this picture painted by the statistics, at least as far as France is concerned, hardly conforms to that indicated by business surveys, which has tended to be positive. This being so, the slowdown in Q3 can be regarded partly as an accidental phenomenon.

However, there was indeed a turning point in firms' inventory behaviour. For the second consecutive quarter, stocks rose substantially in France and similar behaviour was to be seen in Germany. Part of this movement was a result of a particular phenomenon in the aircraft-building sector, but the high level of stocking also revealed forecasting errors by firms in the two countries. French importers, in particular, had failed to assess correctly the scale of the levelling off in domestic demand. In these circumstances, the margin rate for French non-financial companies deteriorated in Q3 2004, under the combined impact of the unexpected slowdown in activity and the surge in raw material prices, notably for oil and metals.

Even so, this downturn in the margin rate is not sufficient to explain the decline in corporate investment recorded in Q3. This seems particularly difficult to interpret in the light of the traditional determinants of investment, especially at a time when pressures on productive capacity were reemerging. All this meant that Q4 2004 is likely to have seen a twofold correction in corporate demand: downward in the case of stocks and upward in the case of industrial investment.

From now on, admittedly, French firms will still have the advantage of particularly favourable financing conditions, but the deterioration in the outlook for external demand — as well as the more widespread "wait-and-see" attitudes affecting domestic demand — can be expected gradually to curb spending on equipment, although this would nevertheless remain positively headed (a halfyearly rise of 1.5% in H1 2005).

A timid recovery in dependent employment is likely to be confirmed in France, where, unlike Germany, the purchasing power of wages would not suffer from past rises in inflation.

In France, the past recovery in activity was only moderately beneficial to dependent employment in the market sector in 2004, with numbers rising by only 0.2% and job creations limited to 35,000.

Even though, because of the Q3 "hiccup", the productivity upswing turned out to be exceptionally brief by historic standards, Q4 2004 and H1 2005 are likely to see dependent employment in the competitive sector rise at a steady rate of 0.1% per quarter, meaning an increase of 25,000 jobs in the first six months of next year. In addition, the number of publicly-aided contracts in the non-market sector is likely to stabilise, so that total employment would rise by 57,000 over the same period.

At the same time, the pension reform carried out in 2003, which via the impact of the possibility of lengthening contribution periods, gave an incentive for some of those eligible to retire in 2005 to postpone their departure, growth in the labour force is expected to accelerate slightly next year. All things considered, the unemployment rate would show only the faint beginnings of a decline, from 9.9% in October 2004 to 9.7% at end-June 2005.

The past rise in inflation, combined with this gradual improvement on the labour market, would help to keep wages rising through into Q1 2005. In Q2 2005, however, the year-on-year increase in wages per head is expected to decline slightly, on the back of the moderation of consumer prices. This means that growth in the average wage per head in purchasing power terms would amount to roughly 1%, year on year, at the end of the first half.

By contrast, in France's euro-zone partners, the past acceleration in prices has been only partially reflected in wage increases. In Germany, where there are still no signs of a recovery in dependent employment, the severe wage restraint seen since the beginning of 2004 is likely to predominate, with many firms signing agreements providing for increases in the workweek without any compensation as regards wages.

This means that the rise in the oil price in the middle part of 2004 would have had only a very short-lived influence on inflation. In France, the rise in inflation was interrupted in September and the easing that began at that time is expected to continue between now and end-June 2005, the result being to bring the year-on-year rise in the consumer price index back to 1.7% in Q2 2005. Admittedly, the past rise in prices of industrial raw materials is likely to lead to an acceleration in prices of manufactured goods, tending to drive up core inflation, but this tendency should nevertheless remain limited, inasmuch as there now seems no chance of the rise in the oil price triggering off a major slippage in inflation of the kind seen in 1973 or 1979 *(cf. special article "The oil price: are we to expect an inflationary spiral?")*. In the euro zone, too, after the inflation peak seen in October under the impact of energy prices, an easing seems to be now under way that is likely to continue until June 2005, bringing annual price rises back to around 1.8%.

However, evolutions in purchasing power are unlikely to result in a clearcut consolidation of French household consumption following the small upturn at the end of 2004

Despite this notable absence of any tendency towards an inflationary spiral in France's partner countries, the purchasing power enjoyed by European households did indeed suffer temporarily from the surge in oil prices. After two years of virtual stagnation (+0.2 % in 2002 and +0.3 % in 2003), the purchasing power of household income in the euro zone seems to have risen only moderately again in 2004 and the same is likely to be true of the early part of 2005, the probable result being to weaken the domestic underpinnings of European growth.

In France, following an upturn towards the end of 2004, the purchasing power of household income seems set to slow down in H1 2005. The growth in the total wage bill is expected to settle down at a steady rythm, with the slow growth in employment offsetting the slight slowdown in the average wage per head. Moreover, social benefits are likely to ac-

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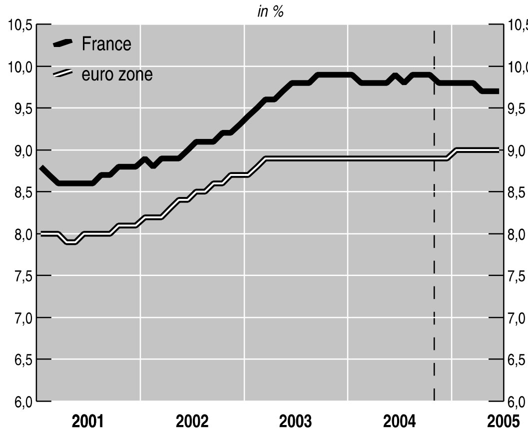
FRANCE AND EURO ZONE: UNEMPLOYMENT RATE

in %



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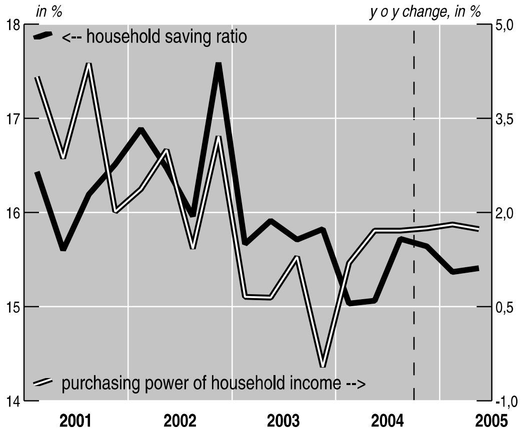
celerate at the beginning of next year, because of increased payouts by private healthcare schemes in the form of reimbursement of prescriptions and market-sector healthcare services. At the same time, however, households' income tax payments (including the Generalised Social Contribution and Contribution to the Reduction in the Social Debt) can be expected to accelerate appreciably, as a result of the measures taken with respect to the health insurance system. In total, household purchasing power is expected to show a rise of 1.6% in 2004, compared with 0.5% in 2003. However, over the time horizon of this projection, it is expected to slow down from a half-yearly rate of around 1.2% in H2 2004 to 0.5% in H1 2005. The statistical carryover for purchasing power in mid-2005 would then be 1.3%.

These erratic movements in purchasing power are reflected in the fluctuations in consumption seen in the past year. After drawing on their savings and taking out consumer credit in the first half of 2004, households chose to reconstitute part of their savings in Q3. Subsequently, household consumption is thought to have rallied again in Q4, perhaps temporarily boosted by the measures relating to cash gifts inter vivos and to savings schemes, as well as by the agreement on price cuts in large-scale distribution signed on 17 June, which may have had a slight moderating impact on inflation. In 2004 as a whole, households are thought to have increased their spending by 2.1%, by saving less. The evolution in their purchasing power in the early part of 2005, in the absence of any new incentive to dissave, would put a cap of the order of 0.4% per quarter on growth in their consumption.

At the same time, however, households' investment in housing is likely to remain vigorous. Starts are still showing a very positive tendency and this firmness of demand is confirmed by real-estate promoters' responses to a survey of the construction industry in October 2004.

4

FRANCE: SAVING RATIO AND HOUSEHOLD INCOMES



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The return to average growth rates in the various segments of demand is likely to even out activity rates as between the different branches

Because of the accidental nature of the evolutions in Q3 in certain segments of demand, notably corporate investment and stocks, a significant upturn in activity is thought to have taken place in all branches in Q4 2004. As a result, the growth rate for manufacturing production is expected to reach 0.9% after stagnating in the previous three months, benefiting, on the one hand, from an upward adjustment in domestic demand and being depressed, on the other, by the reduction in the stock levels involuntarily built up during the year. **GDP is expected to show a rise of 0.6% in Q4 2004, bringing growth for the year as a whole (adjusted for the number of working days) to 2.1%,** corresponding to roughly 2.3%-2.4% in the absence of working-day adjustment.

At the beginning of 2005, under the combined impact of the rundown in foreign trade and greater restraint shown by firms and households, production is expected to return to average growth rates. Manufacturing production, in particular, would rise more moderately than at the end of 2004, as a result of the gradual downturn in exports and in household consumption, bringing down with it energy production and transport.

Investment in domestic housing would nevertheless continue to provide support for the construction industry. Household demand for dwellings, especially apartments, seems set to remain brisk and continue to stimulate activity in the sector. Activity in services would regain a certain liveliness: according to the November survey, the business climate in this sector has deteriorated slightly but remains favourable. At the beginning of 2005, the growth rate for activity in market-sector services would therefore be close to 0.5% per quarter, in line with the return to normal of household consumption. Meanwhile, production in non-market services would return to a growth rate of the order of 0.7%. Finally, the general outlook for activity in wholesaling and retailing has been deteriorating since July 2004, indicating a return to less firm growth rates, thought to be related to the slowdowns in household consumption and corporate demand.

In the final analysis, this return to average growth rates in all branches suggests GDP growth of 0.5% in Q1 2005 and 0.4% in Q2.

There are two main uncertainties attached to this forecast. First, how oil prices will move remains very uncertain, with a sharp fall possibly constituting support for demand but a rise generating new inflationary risks. The second uncertainty stems from the dollar, which, if it were to continue to slide for any great length of time, would profoundly modify the diagnosis regarding all world markets. ■