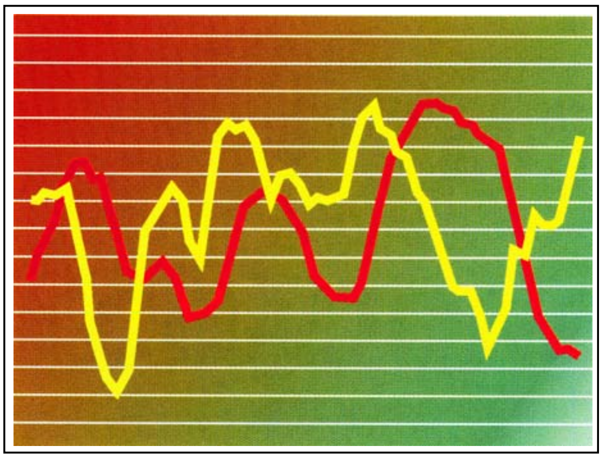
CONJONCTURE IN FRANCE

DECEMBER 2005



A RETURN TO TREND GROWTH

INSEE

A RETURN TO TREND GROWTH

After a slow second quarter, growth in the euro zone picked up again in the summer, mainly reflecting a more positive contribution to growth in the zone from its international environment. World activity remained very strong and the euro exchange rate fell back from its peaks in the early part of the year. In France, the rise in GDP in Q3 was the result, in addition, of very firm household consumption, but this tended to weaken slightly in the autumn. However, against a background of a calmer oil situation, the indications given by the business surveys are pointing to a steady continuation of growth, leading to a GDP rise of the order of 0.5% in Q4. French growth in 2005 is accordingly expected to be around 1.6%. Household consumption, still the main driving force for growth, is thought to have risen by 2.0%, despite a certain degree of caution on the part of consumers, expressed both in their expectations as revealed by the business surveys and by the virtual stabilisation of the saving ratio. And yet the unemployment rate has been falling since June and could well be close to 9.5% by the end of December (compared with 10% at the end of 2004). However, dependent job creation in the market sector remains modest (60,000 in 2005), as a result of the continuing decline in industrial employment. Corporate investment growth appears to have been at a long-term average rate in 2005 (3.3%, compared with 2.3% in 2004), while at the same time foreign trade continued to make a negative contribution to growth in accounting terms (-0.8 of a point, compared with –1.1 point in 2004). As a result, 2005 was characterised by an industrial climate that was weaker than in the rest of the economy, marked by strong housing-based activity.

The eve of 2006 finds the dynamism of the euro zone's international environment intact, despite the oil shock. The American economy is still growing strongly, despite the steady succession of hikes in the Federal Reserve's intervention rate, which have admittedly had only a very modest impact on long rates. In this favourable external climate — especially as the oil price and the euro exchange rate seem to have stabilised — euro-zone growth is expected to show a quarterly rise of 0.4% in the first half of next year. It is likely to remain limited by the modest nature of domestic demand in certain countries, notably Germany, linked to low wage growth. However, purchasing power should benefit from an easing of inflation (2.0% in the euro zone and 1.5% in France in June 2006). As a result, consumption in France is expected to increase in H1, permitting GDP growth of slightly over 2% at annualised rate. With the private workforce showing modest growth of 30,000 in the half-year, accompanied by a smaller increase in the labour force and a continuation of the effects of the policy of aided employment, the unemployment rate seems set to continue to decline, reaching 9.2% in June.

One uncertainty of a positive nature that could affect these prospects is a possible firming of household demand as a result of the improvement on the labour market. Conversely, the evolution of the oil price, in a market that will remain tense, is likely to remain highly sensitive to accidents liable to affect production. ■

The improvement posted by the French economy in Q3 was surprisingly large. In an admittedly favourable international context, the resilience of domestic demand, and especially of corporate investment in construction and in services, pushed quarterly GDP growth to 0.3 of a point above our October forecast. As a result, French activity, boosted by demand from households and firms, is expected to show growth of 1.6% for the year 2005 as a whole and to settle down in the early part of 2006 at an annualised rate of slightly above 2.0%.

A fully apparent oil shock, but with still only a subdued effect

After peaking at $67 in September, the Brent price began to fall back because of the steady consolidation of world supply and continuing weak demand for petroleum products in the run-up to the winter season. Even so, the market remains tense and the current stabilisation of the Brent price leads us to adopt an assumption of $56.5 per barrel for the final quarter of 2005, followed by $55 in the first half of 2006.

The consequences of the rise of $25 in oil prices in the space of two years are fully tangible, but are turning out at present to be narrowly confined. The French energy bill has risen from 1.4 GDP points in 2003 to 2.1 points in the first three quarters of 2005 and a similar phenomenon could be seen in all the oil-importing countries, the result being a transfer of wealth towards the exporting countries amounting to a cumulative total of 1% of world GDP in 2004 and 2005, probably partly clawed back through higher imports by the producing countries.

Nevertheless, the major industrialised countries are not reliving the traumas caused by the oil shocks of the 1970s. The rise in prices has been more evenly spread over time than in the previous crises and this has permitted adjustments to be made. Furthermore, the energy intensity is now much smaller than it was at the time of the earlier shocks and the monetary context is also now very different. Lastly, the increasingly competitive environment is exerting strong downward pressure on prices and this is hampering the process of transmission of the higher prices to the real economy *(see the special article «A subdued oil shock»)*.

In France's leading industrial euro-zone partners, as well as in Asia, the oil price shock has generally been satisfactorily absorbed this year and this situation is likely to last in H1 2006. The euro-zone industrial partners are expected to post growth rates similar to those seen in the second half of 2005, given that domestic demand in these countries can be expected to maintain its momentum. In the United States, the United Kingdom and Japan, households are likely to benefit from an improvement on the labour market. In the English-speaking countries there should be additions to real income as the result of an easing of inflation, the direct consequence of a decline in the energy contribution to variations in price indices. These favourable tendencies should prompt firms to launch new investment projects. All things considered, annualised growth rates in H1 2006 are expected to be of the order of 3.5% for the United States, 2.2% for the United Kingdom and 2.4% for Japan.

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

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

		2004				2005				2006		2004	2005	2006 co
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
GDP	(100%)	0.5	0.8	0.0	0.7	0.3	0.1	0.7	0.5	0.5	0.6	2.1	1.6	1.7
Imports	(28%)	0.4	3.6	1.6	1.4	0.7	1.4	2.3	1.3	1.6	1.5	6.1	6.1	5.4
Consumption	(54%)	0.7	0.8	-0.3	1.2	0.7	-0.1	0.7	0.3	0.7	0.6	2.3	2.0	1.7
Public consumption*	(24%)	0.7	0.8	0.0	0.7	0.1	0.0	1.1	0.4	0.4	0.6	2.7	1.5	1.7
Investment	(19%)	-0.4	1.0	-0.3	1.3	1.5	-0.1	0.9	0.8	0.8	0.8	2.1	3.1	2.5
of which:														
Non financial corporated and unincorporated enterprises	(11%)	-0.4	1.2	-0.6	1.7	1.9	-0.9	1.1	0.9	0.9	0.9	2.3	3.3	2.6
Households	*(5%)*	0.4	1.6	0.5	0.8	0.7	1.1	0.4	0.8	0.8	0.7	3.1	3.2	2.3
Exports	(29%)	0.2	1.1	-0.3	1.1	-0.2	1.0	3.1	1.4	1.4	1.6	2.1	3.5	5.5
Contributions to growth														
Internal demand ex. inventory changes		0.5	0.9	-0.2	1.1	0.7	-0.1	0.9	0.4	0.7	0.6	2.3	2.1	1.9
Inventory changes		0.1	0.6	0.8	-0.3	-0.1	0.3	-0.4	0.0	0.0	-0.1	0.8	0.2	-0.2
Net foreign trade		-0.1	-0.7	-0.5	-0.1	-0.3	-0.1	0.2	0.0	-0.1	0.0	-1.1	-0.8	0.0

Forecast
* Public consumption and NPISH
Weight in 2000 in brackets

Disparate evolutions in domestic demand in euro-zone countries in the early part of 2006

In the euro zone, no second-round effects of the oil shock have been detected. Inflation in the zone, pushed up by the rise in the oil price, rose from 2.1% in June to 2.5% in October and is expected to remain around 2.4% in December. In H1 2006, however, against a background of very slow wage growth, core inflation is likely to remain stable around 1.4%, while the year-on-year rise in energy prices eases back. All things considered, inflation is expected to ebb gradually to settle down at 2.0% in June. The ECB on 1 December decided to raise its key rates by 25 basis points after leaving them unchanged for 2 1/2 years. The impact on European long rates has been very small, but the move could trigger a slowdown in house prices in the zone.

Activity in France and Germany, only slightly hampered by the oil shock, picked up strongly in Q3, leading to robust GDP growth in the euro zone as a whole (0.6%). This rally seems to have been the result both of the revival in domestic demand that is still of a one-off nature and of an appreciable and more lasting improvement in foreign trade, given that the international situation as seen from the euro zone is showing improvement around the turn of the year, thanks both to firmer demand and to the recent decline in the euro versus the dollar (for forecasting purposes, a conventional assumption of $1.18 to the euro has been adopted). This improvement is in fact reflected in the improvement in responses to business surveys up to November.

Starting in Q4, GDP growth in the euro zone is expected to return to a quarterly rate of 0.4%. The growth in corporate investment and the firmness of world demand are not expected to make up for the weakness of private consumption. The low level of job creation and the stagnation of wage growth can be expected to continue to hold back growth in household incomes, and this would continue to weaken the domestic driving forces for European growth. For the year 2005 as a whole, GDP is likely to rise by 1.4% and the statistical carryover for growth is expected to be 1.5% in the middle of next year.

This mediocre growth can be expected to show considerable differences in countries' economic situations. In particular, France and Germany are likely to take fairly different growth paths. In Germany, firms continue to gain market share as the result of improvements in cost-competitiveness resulting from the decline in real wages, leading to a revival of productive investment. Even so, the continuing decline in real wages and the slackness of the labour market make it impossible to envisage any significant recovery in German household demand in the early part of 2006, in contrast to the situation in France.

A belated recovery in the French manufacturing sector

In line with the latest surge in the oil bill, the French current-account deficit worsened further in Q3 (a cumulative total of -20 billion in the first three quarters of the year). And yet the upturn in industrial exports was fully confirmed in Q3. Even though uncertainties persist regarding the sustainability of French non-price-competitiveness, against a background of aggressive positioning on the part of its principal trade partner (Germany), French exports are expected to rise at a steady rate until the middle of 2006, on the back of slightly more propitious European demand and a more favourable euro exchange rate.

This improvement in foreign trade has not immediately put an end to the seizing up of manufacturing output (a decline of 0.2%, following + 0.3% in Q2 and - 0.3% in Q1). This poor performance by French industry, probably partly the result of calendar phenomena, is due mainly to weak activity in the automobile branch during the summer, without this signalling any real cyclical downturn. This decline in car production is in contrast to activity in all the other manufacturing sectors, reflected in the improvement in the business climate since Q2 2005. The more favourable tendency shown in the surveys suggests a recovery in manufacturing activity starting in Q4 as a direct consequence of the strength of exports

An upturn in dependent employment, supplemented by the acceleration in the programme of aided employment, is expected to bring the unemployment rate down to 9.2% in the middle of next year

The evolutions in the unemployment rate in Q3 testify to the continued improvement on the labour market. As a result, 2005 should see an increase in total employment of almost 120,000, under the combined impact of the moderate recovery of dependent employment, the jobs created by the build-up of the measures contained in the government's «Social Cohesion Plan» and the steady rise in non-aided non-market employment.

With almost 60,000 dependent jobs created in the non-farm competitive sectors, the year 2005 has clearly signalled the beginnings of recovery following the stagnation seen in 2004. Despite the somewhat seesaw pattern of economic activity during 2005, growth in market employment is likely to settle down in the early part of 2006 at a modest quarterly growth rate of the order of 0.1%, equivalent to a rise of more than 30,000 jobs in the first half of next year.

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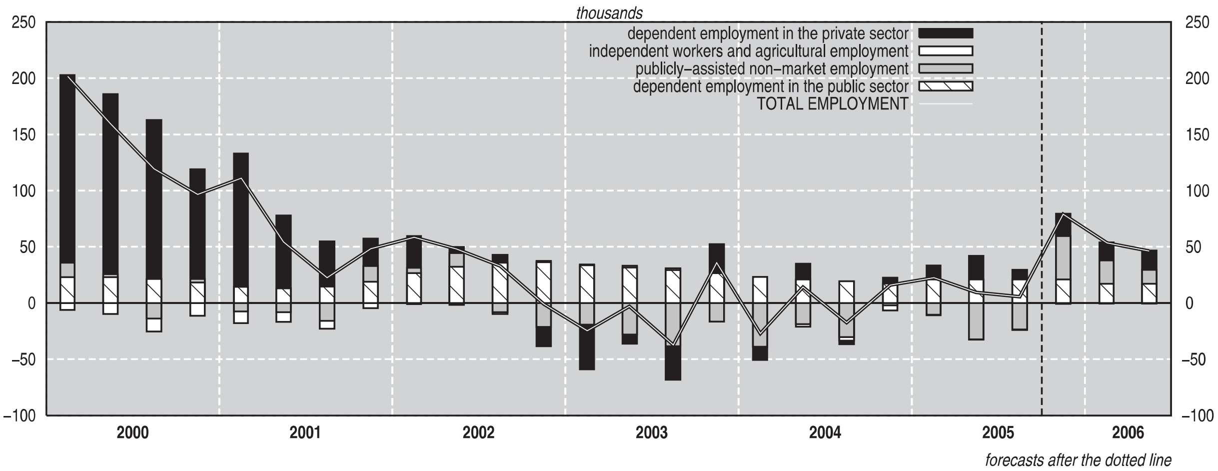
EVOLUTION IN EMPLOYMENT



In addition, the mechanisms for aided employment in the non-market sector can be expected to contribute to a continuing decline in the unemployment rate. While aided non-market employment has continued to decline throughout 2005 (by 28,000), the recovery in Q4 2005 is likely to intensify in H1 2006, with the stock moving positively for the first time in three years, showing a rise of 33,000.

By the end of H1 2006, total employment is likely also to show a rise, of around 100,000 jobs. This acceleration would be underpinned by the increase in the number of beneficiaries of aided non-market employment, by a continuing firm level of job creations (excluding aided employment) in the non-market sectors and by an upturn in dependent employment in the competitive sector *(see Graph 1)*.

The supply of labour is thought to have slowed down considerably in 2005 and can be expected to continue to do so in 2006. As a result, the unemployment rate as defined by the ILO, after reaching 9.7% at the end of 2005, should decline to 9.5% by the end of the year, before continuing to ease to 9.3% at the end of Q1 2006 and 9.2% at the end of June.

The gradual recovery in household purchasing power likely to be confirmed

The most tangible effects of the surge in oil prices are to be seen in consumer prices. Between June and September 2005, French inflation accelerated from 1.7% to 2.2%. However, this tendency was abruptly cut short by the easing of oil prices in the autumn. Combined with the restraint shown by food prices and, even more decisively, by the continuing decline in prices of imported manufactured goods, this easing is expected to keep inflation down to 1.7% in December 2005. The year-on-year rise in energy prices is likely to lose further ground in the early part of next year, returning to 1.5% in June, with core inflation stable at around 1.2% *(see Graph 2)*.

The rise in the total wage bill, in the wake of the upturn in total employment, continues as a result to win out over inflation. In 2005, the recovery in total real wages, backed up by the acceleration in other components of income, was offset by the acceleration in tax receipts from households following the rise in the rate of CSG (General Social Contribution) and in the extension of its base. The end of 2005 should see

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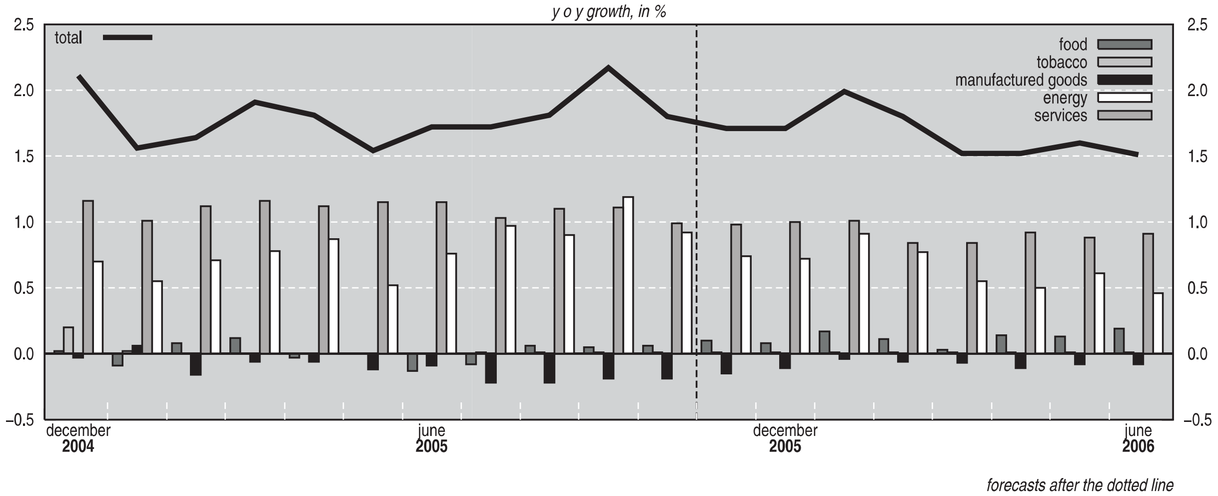
BREAKDOWN OF INFLATION IN FRANCE
contributions of the main items



the upturn confirmed in all the real components of income — earned income, dividends paid by companies, gross operating surplus of unincorporated enterprises and households —, while at the same time levies on income can expected to slow down. As a result, the tendency for income purchasing power to accelerate that was faintly visible in 2005 (+ 1.9%, compared with 1.6% in 2004) can expected to intensify in the early part of next year.

Household expenditure given a new lease of life as a result

After a sharp rise in consumption during the winter of 2004-2005, household expenditure fell back in Q2 (by 0.1%), before again rebounding sharply in Q3 (+0,7%). This upturn is partly linked to the continuing firm growth rate for spending on healthcare services as recorded in the statistics of the CNAM (National Sickness Insurance Fund). These fluctuating evolutions point to a further automatic correction in the growth of consumption in the final quarter, especially spending on manufactures. All things considered, average annual consumption growth is expected to be 2.0%, corresponding to virtual stability of the saving ratio.

In the first half of 2006, the favourable growth in the purchasing power of income, against the background of an improved labour market, should install consumption growth at rates of the order of 0.6% to 0.7% per quarter. On top of this firmness of private demand, there is likely to be added the normalisation of growth in individual expenditure by general government, which had already seen a sharp upturn in Q3 following the particularly marked slowdown recorded this year, partly attributable to reforms in the healthcare field: following a rise of only 1.2% in 2005, the statistical carryover for individual expenditure by general government is expected to reach 2.0% by the end of H1 2006.

Meanwhile there was no slackening in the strength of investment by households at any time during 2005. This was due to an excess of demand for housing over the supply, to historically low long-term interest rates and to the tax advantages accompanying investment in housing for rental purposes. The latest figures for starts indicate that housing investment will remain firm in the early part of 2006. The persistence of strong investment by households is keeping the financial saving ratio at historically low levels, and this is increasing the possibility of a downturn, especially now that the ECB has raised its key rates.

Companies remaining circumspect regarding their investment prospects

The particularly marked rally in corporate investment in Q3 can in large part be interpreted as a correction of the exceptional fall posted in Q2.

Even so, the gloom enveloping industry in 2005, together with the slight erosion of profitability due to the surge in prices of energy inputs, is probably prompting firms to be prudent in their investment decisions, as the October investment survey showed. In coming quarters, the investment ratio should rise very gradually. Productive investment can be expected to show a steady evolution although falling short of indisputable recovery, rising by around 0.9% per quarter, while the recent strengthening of investment in construction and public works is likely to be confirmed.

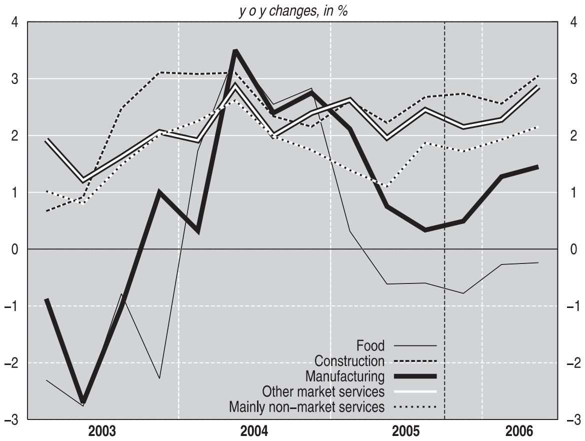
The cyclical divergence between industry and services is tending to be confirmed in the final months of 2005

Following a lacklustre first half of 2005, production in all branches taken together rose by 0.6% in Q3, but showing an increasingly contrasting picture between individual French productive sectors. While the levelling off in manufacturing already identified at the beginning of the year intensified, activity was particularly firm in the non-industrial branches *(see Graph 3)*. The sharp increase in household expenditure brought with it stronger activity in distribution and personal services. Output of business services strengthened, notably because of a recovery in advisory and assistance services. Construction activity accelerated further as a result of the upturn in public works.

3

PRODUCTION BY BRANCH

y o y changes, in %



forecasts after the dotted line

In the next few quarters, output in the non-industrial branches is set to rise further, although at a slightly more moderate rate. After a technical pause for breath in Q4, output of market services and of distribution are likely to benefit from the revival in household consumption, growing at a quarterly rate of the order of 0.7% to 0.8%. As regards the mainly non-market services, the return of growth in healthcare spending to more traditional rates can be expected to provide support for the sector.

Finally, as a result of the simultaneous liveliness of investment by households, firms and public authorities, the construction sector seems set to remain firm in coming quarters (following a rise of 2.6% in 2005, the statistical carryover at the end of H1 2006 is expected to be 2.3%).

The only branch likely to show a weakening in the early part of next year is manufacturing, posting a less brisk growth rate of the order of 0.5% per quarter, with much of the household expenditure on manufactures tending to benefit imports.

In total, French GDP growth 2005 is expected to come out at 1.6%. Quarterly GDP growth is expected to return to a rate of 0.5% in Q4 2005 and Q1 2006, before rising to 0.6% in Q2.

Given that the main driving force behind this form of growth is undoubtedly domestic demand, there is one potential uncertainty hanging over this scenario, namely the possibility that growth could be further eroded by a renewed surge in imports. An uncertainty that is potentially positive is the possibility that household demand might strengthen over and above the projections of brisk growth, under the impact of a still more pronounced improvement on the labour market. It goes without saying that the oil price remains a factor of uncertainty, but even the direction its influence might take is itself uncertain. ■