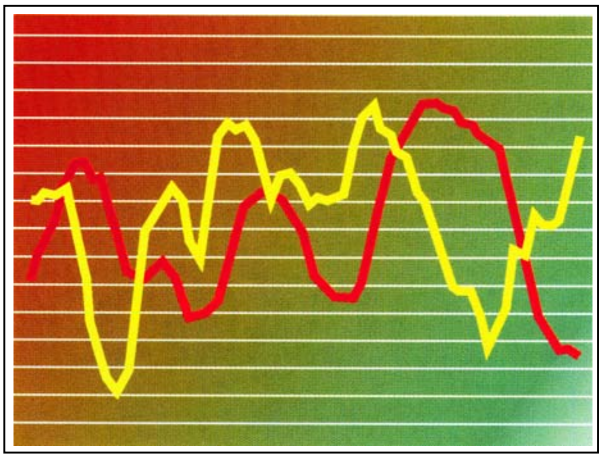
CONJONCTURE IN FRANCE

MARCH 2005



SLOW-PACED RECOVERY

INSEE

SLOW-PACED RECOVERY

With 2.5% growth (2.3% after adjustment for the number of working days), 2004 emerges clearly as the year of an upturn for the French economy. However, the process was interrupted in mid-year. The first half of 2004 formed part of the distinct recovery phase that had begun in mid-2003 in the wake of the upturn at world level. The second half of the year, when the tendency was more uneven and when the oil price was rising strongly, marked a shift to a period of less robust growth. For the year as a whole, growth was underpinned by domestic demand, while the contribution from foreign trade remained negative. French exports benefited very little from a highly dynamic world environment and were restricted by the slackness of demand in neighbouring European countries. The return to growth allowed an increase in employment starting in the second quarter but progress has remained weak. Even so, unemployment stabilised over the whole of the year, thanks notably to the large number of cessations of activity.

The early part of 2005 finds demand in the euro zone's export markets gradually slowing down, with activity becoming less brisk in both the United States and Asia. Growth in the zone itself is expected to remain moderate, even though domestic demand, bolstered mainly by highly favourable monetary conditions, seems somewhat firmer in the early part of 2005 than at the end of 2004. Moreover, business leaders' expectations, affected by variations in the exchange rate and the oil price, are still hesitant.

France continues to stand out from its main neighbours by reason of its lively consumption, benefiting from the knock-on effect of a very active housing market and stimulated by temporary support measures. However, the vigour shown by consumer spending can be expected to level off during the adjustment to moderate growth in purchasing power, even though inflation continues to ebb (1.5% in June, assuming that the oil price returns to around 40 $/barrel). The outlook for both domestic and external demand explains why investment growth is set to remain moderate. The result for the first half of 2005 is therefore expected to be self-sustained growth of around 2%, especially as an underlying productivity growth tendency of the order of 1.6% should generate slow growth in market-sector dependent employment (by 27,000 in H1 2005, compared with 20,000 in 2004). In these circumstances, the unemployment rate can be expected to stabilise (9.9% in June) after peaking in the early part of the year.

The uncertainties hanging over these short-term tendencies lie, as they have done for the past year, in the dollar exchange rate and the oil price, both of which remain highly volatile. In the short term, there are also question-marks regarding the behaviour of firms and households in France's principal neighbours, which showed surprisingly great prudence in the past year and gave the impression of somewhat anaemic domestic demand in the euro zone. ■

Slowdown in the euro zone towards the end of 2004

Thanks to the dynamism of the American economy and the economic expansion of several high-growth countries (China, India, Central and Eastern Europe), the world economy in 2004 posted a level of growth not seen for 20 years (around 4.5%). Even so, French exports largely failed to benefit, rising by no more than 3.2%, well below their average growth in the previous upswing (4.8%). The deterioration amounting to 8.8 billion euros in the current-account is largely explained by the persistent cyclical lag between France and its principal partners, Germany and Italy. Whereas French growth reached 2.3% (after adjustment for the number of working days), GDP in the zone as a whole is estimated to have risen by only 1.8%. The divergence between domestic demand in the various countries is even more marked, especially in the case of Germany, where the considerable weakness of both corporate and household demand was a constant feature throughout the year.

The disappointing performance of French exports can be linked, in particular, to a question of positioning. The combination of a geographic and a sectoral fragmentation that are unfavourable in both cases was a restraining influence on French exports, in contrast to the German positioning.

The first signs that world demand was running out of steam were in fact distinctly visible as early as Q3 of last year, the result being to compound the current weakness of the Italian and German economies. This worldwide downturn resulted from the first stages of monetary tightening in the English-speaking countries, aimed at forestalling any risk of overheating that might affect prices of goods and assets, notably housing. This tendency was encouraged by the surge in the oil price to within a range of 40-50 USD/barrel, a surge that has still not worked itself out. At the same time, European exporters have had to cope with the steep fall in the dollar versus the single currency, which has substantially impaired their price-competitiveness.

This weakening of the world economy is expected to continue in H1 2005. Growth in the United States is likely to ease by a few tenths of a point, bringing it to around 3.5% at annualised rate after reaching almost 4% at the end of last year. Activity in Asia is set to slow down, with the Chinese policy of curbing investment starting to take effect. While Japan should post a recovery, this is likely to be limited growth of around 0.2% per quarter. All in all, demand in the euro zone's export markets is likely to slow down significantly in H1 2005. On the conventional assumption that the euro remains at 1.3 USD, exports to outside the euro zone would then weaken from year-on-year growth of 6.9% in Q4 2004 to 4.0% in Q2 2005.

In the euro zone, helped by tax measures to bolster households' incomes and against a background of incipient recovery in productive investment, country situations are likely to become less heterogeneous and growth can be expected to pick up, notably in Germany and Italy. Moreover, the zone as a whole is expected to benefit from an easing of inflation to 1.6% in mid-2005 from a peak of 2.4% at the end of 2004. However, domestic demand would remain too fragile to breathe fresh life into the recovery: the statistical carry-over [*] for euro-zone growth would be

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%)	**0.1**	**-0.4**	**1.1**	**0.6**	**0.7**	**0.7**	**-0.0**	**0.8**	**0.6**	**0.3**	**0.5**	**2.3**	**1.6**
Imports	(27%)	-0.2	-0.5	-0.2	2.8	1.1	3.7	2.3	1.1	1.3	1.2	0.2	7.4	5.1
Consumption	(54%)	0.6	-0.3	1.0	0.3	1.1	0.4	-0.2	1.2	0.8	0.3	1.6	2.2	2.0
Public consumption	(23%)	0.2	0.3	0.9	0.9	0.5	0.8	0.2	0.6	0.7	0.6	2.5	2.6	1.9
Investment	(20%)	-0.0	0.2	1.2	1.5	0.5	1.5	-0.5	0.9	1.0	0.6	0.2	3.3	2.3
of which:														
Non financial corporated and unincorporated enterprises	(12%)	*-0.7*	*-0.1*	*1.4*	*1.5*	*0.2*	*1.3*	*-1.1*	*1.2*	*1.2*	*0.8*	*-1.6*	*2.8*	*2.5*
Households	(5%)	*0.2*	*0.2*	*0.0*	*0.6*	*0.9*	*2.3*	*0.5*	*1.1*	*1.3*	*0.6*	*0.8*	*3.7*	*3.4*
Exports	(29%)	-2.2	-1.4	0.9	1.4	0.6	1.0	0.5	1.3	1.0	1.0	-2.5	3.2	3.3
Contributions to growth														
Internal demand ex. inventory changes		0.4	-0.0	1.0	0.7	0.8	0.7	-0.2	1.0	0.8	0.5	1.5	2.5	2.0
Inventory changes		0.3	-0.2	-0.2	0.3	0.1	0.7	0.7	-0.3	-0.1	-0.1	-0.2	0.9	0.2
Net foreign trade		-0.6	-0.3	0.3	-0.4	-0.1	-0.7	-0.5	0.0	-0.1	-0.0	-0.8	-1.2	-0.6

Forecast
* Carry over effect at Q2.

no more than 1.1% in mid-year, making the possibility of the engagement of a virtuous spiral in terms of investment[1] and employment somewhat uncertain.

In the short term, in the case of France, the slowdown at world level should be temporarily cushioned by the recovery in domestic demand in the euro-zone countries, with French exports maintaining a growth rate of 1% per quarter.

A winter improvement driven by household spending

The story of the French economy in the winter of 2004-2005 appears so far to have been very different from those of its European partners, since it continued to benefit from domestic demand that was distinctly more favourably headed than in Germany and Italy, as regards both consumption and investment.

This meant that, in contrast to the situation in Germany, investment by households was very lively throughout 2004, underpinned by favourable financial conditions[2]. To judge by the latest figures for housing starts, household investment seems set to accelerate further in Q1 2005, before levelling off in Q2.

More generally, it is indeed the behaviour of French households that contrasts most strongly with those of German and Italian households. In 2004, against a background of modest growth in their purchasing power (1.6% over the year), French households reduced their saving in order to finance expenditure on consumption (with the saving ratio declining by 0.5 of a point between 2003 and 2004). The decline in spending in Q3 admittedly exposed the fragility of consumption as a driving force, but in Q4 2004 (and probably again in Q1 2005 according to preliminary indications) the decline in the saving ratio has continued, giving a further boost to consumption, with growth of 1.2% in Q4 2004 and 0.8% in Q1 2005. Part of this dynamism can probably be attributed to measures intended to support consumption. Between 1/10 and 2/10 of the sums derived in this way, either through grants or the unfreezing of corporate savings plans, may have found its way into the spending of French households around the turn of the year (see box on the impact of measures in 2004 to support consumption, available in French only).

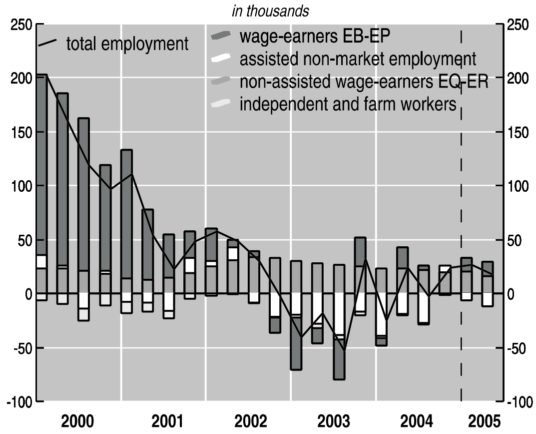
However, if this assumption turns out to be true, it means that when these measures come to an end household consumption can be expected to move back in line with its usual determinants (essentially, the purchasing power of income and the levels of

(*) In other words, the average figure for the year, assuming zero growth in the remaining period.
(1) See box entitled «L'investissement en équipement va t-il accélérer en zone euro ?» (available only in the French version).
(2) See special article: « Are we seeing a bubble on the french housing market?» on page 9 .

1

COMPOSITION OF EVOLUTIONS IN TOTAL EMPLOYMENT

in thousands



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employment and inflation) and this would automatically mean a recovery in the saving ratio. Household consumption could then be expected to mark time as of Q2 (0.3%).

The unemployment rate to remain flat at around 10% until mid-2005 ...

The recovery in total employment remained timid in 2004 (an additional 20,000 jobs for the year as a whole) and no marked acceleration is expected in H1 2005. The «soft patch» in growth in Q3 2004 choked off the upturn in productivity. Admittedly, in the case of dependent employment, Q1 and Q2 2005 are likely to see a consolidation of the upturn, with the creation of 27,000 jobs in the half-year (compared with less than 20 000 for the whole of last year).

In the non-market sector, evolutions are likely to be more of a «stop-and-go» nature. In H1 2005, job creation in the non-market sectors is likely to accelerate, since, assistance measures aside, the increase in employment in these sectors should continue. Above all, the decline in the number of beneficiaries of assisted contracts can be expected to be much less marked than in 2004: for one thing, the number of youth-employment contracts coming to an end would decline further in H1 2005; for another, the new measures forming part of the «social cohesion programme» will start to be implemented. Nevertheless, because of the very gradual build-up of the new arrangements, the net impact on assisted non-market employment is likely to be negative in the first half-year, with a decline of roughly 25,000 in the number of beneficiaries of assisted employment.

All in all, total employment is expected to increase by 41 000 jobs in H1 2005 *(see graph 1)*, much the same figure as for the total labour force. As a result, the unemployment rate is expected to remain stable at around 10.0% (9.9% in the middle of 2005, after a peak of 10.1% at the beginning of the year).

… as a reflection of the slight weakening in purchasing power

Partly as a consequence of the inertia of the unemployment rate, wage incomes are not expected to accelerate in the early part of 2005. Apart from the still modest growth in employment, the evolution in the basic wage is likely to be much the same as in 2004, with the two principal determinants, unemployment and inflation, tending to cancel each other out. The impact of the downturn in inflation, in particular, would be offset by the slight improvement on the labour market and the ending of wage restraint. As a result, year-on-year growth in the average wage per head can be expected to be the same in mid-2005 as it was in 2004 (2.2%, or 0.6% in real terms).

However, household purchasing power would be boosted by strong investment income and continuing disinflation.

Investment income would still show a very positive tendency, under the combined impact of reduced interest charges and the acceleration in dividend payments following the improvement in the situation of the corporate sector. And income would also be helped by the improvement in the cash flow of unincorporated enterprises and households, the latter benefiting from the strong growth in rents.

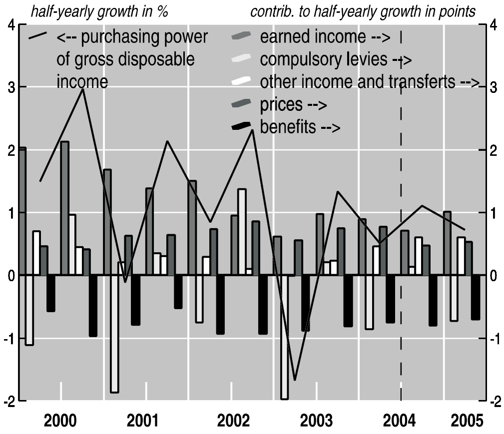
Households should also be able to count on the easing of inflation, which is continuing even more distinctly in the early part of 2005. Helped by the marked slowdown in food prices and the stability of tobacco prices at the end of last year and then by the decline in the year-on-year rise in energy prices this year, inflation is expected to be 1.5% in June 2005, compared with 2.1% in December 2004. It should nevertheless be noted that the year-on-year rise in prices of manufactures and services [3] is likely to increase further in H1 2005, implying a rise in core inflation.

Even so, the growth in wage incomes, which account for 55% of total incomes, is the crucial determinant of the purchasing power of gross disposable household income. In the present case, it is unlikely to be sufficient to compensate for the rise in income tax payments (including the special social insurance and debt repayment contributions) in the early part of this year. In the final analysis, half-yearly growth in household purchasing power is expected to slow down from 1.1% to 0.7% *(see graph 2)*.

(3) See box entitled «Hausses administrées de prix : hypothèses 2005" and box entitled »Les mesures de réforme de l'assurance maladie : conséquences au début 2005" (both available only in the French version).

2

COMPOSITION OF EVOLUTIONS IN PURCHASING POWER



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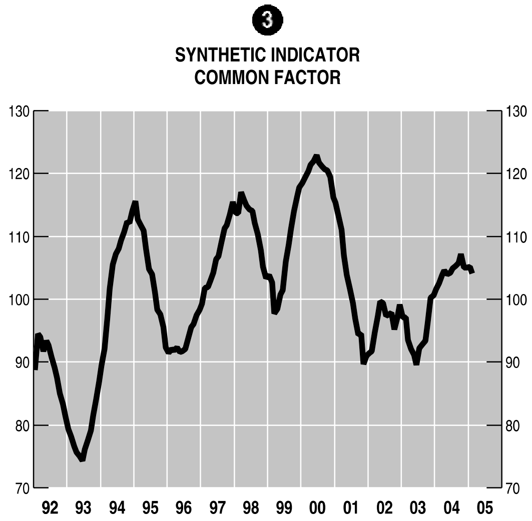
A lacklustre climate prompting firms to remain cautious

The monthly surveys undertaken in February 2005, although continuing to reflect a favourable situation, are bringing together several signs of slowdown in both industry and services. Business leaders' worries can be summarised as follows: admittedly, consumption has so far showed no sign of weakening, but whether it can be maintained depends mainly on whether households are prepared to reduce their saving ratio still further; granted, there is an appreciable improvement in the demand from France's principal foreign partners, but the very high commodity prices and the appreciation of the euro are fuelling concern regarding the profitability of investment.

Finally, while firms opted in the past year for increasing their demand and notably their inventories (giving an industrial-sector contribution to GDP growth of 0.5 of a point) they are now experiencing a steady build-up of stocks of finished products. This suggests a slowdown in inventory accumulation in the early part of the year, notably in the car sector, making a negative contribution to growth in the first two quarters of 2005.

All in all, despite the recovery in the mark-up ratio in the past year and the relative firmness of domestic and export demand, firms remain cautious regarding the outlook for activity. Their worries could explain why corporate investment rose only moderately in 2004, the same restraint being seen in the early part of 2005. With a growth rate of the order of 1% per quarter, the evolution in corporate investment is showing no signs of the existence at this stage of an accelerator-type mechanism, although this is traditional in an upswing phase.



With no new impetus from the demand side, output and GDP are likely to moderate gradually

Finally, output is likely to grow less rapidly than in the last part of 2004. In particular, activity in manufacturing and services is expected to slow down as of Q1, although output in the transport and energy sectors would become firmer.

Manufacturing output rose by 1.0% in Q4 2004, following a dip (-0.3%) in the previous quarter. This rally, which was in line with expectations, masks wide disparities between sectors. Manufacturing activity picked up in the car and capital goods branches, which were stimulated by domestic and export demand for their products. By contrast, it was slack in the intermediate and consumer goods branches. In Q1 2005, manufacturing output is likely to rise by only 0.7%, a rate which is in line with the firmness of the composite indicator of the industrial business climate *(see graph 3)*. The levelling off in prospects for own-firm production in February, as well as in order books, points to a slowdown in Q2 2005 to a rate of 0.3%, in line with the weakening of household consumption and a smaller addition to stocks.

Output of market-sector services, following a dynamic final quarter of 2004 (+1.0%) that was common to both business services and services to individuals, is thought to have returned to a growth rate of 0.6% per quarter at the beginning of 2005.

Activity in wholesale and retail distribution also recovered in Q4 2004 following an adverse Q3. The beginning of 2005 is likely to see continued growth in specialised retailing but a slowdown in wholesale distribution. This is because, while the ordering intentions of the wholesalers questioned in January show no change, the overall outlook for activity is still declining somewhat.

Activity remains firm in the building sector, whereas it has continued to deteriorate in the case of public works, still handicapped by the decline in general government investment. In Q1 2005, activity in the construction sector is expected to grow at a rate close to that seen at the beginning of 2004 (0.5%).

Finally, after bottoming out in Q4 2004, output in the transport and energy sectors will probably become firmer in the first part of 2005. Activity should no longer be held back by the goods transport branch, as the result of the moderate but firm growth in manufacturing output. For similar reasons, energy production should recover, notably because of the cold spell seen this winter.

All things considered, GDP can be expected to rise by 0.6% in Q1 2005 and then by 0.3% in Q2, giving a statistical carryover for growth in 2005 of 1.6%. ■