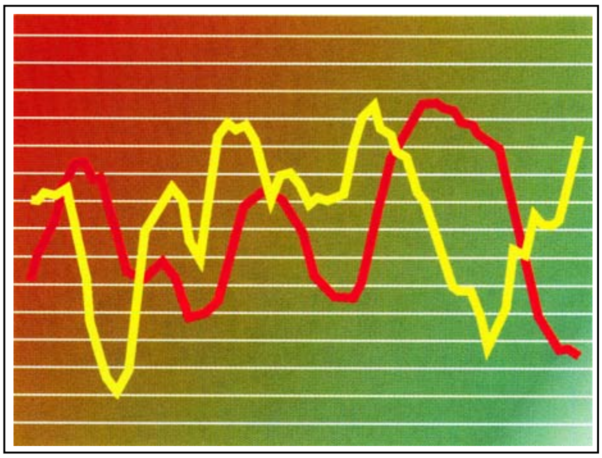
INSEE CONJONCTURE

CONJONCTURE IN FRANCE

JUNE 2005



GROWTH BENDING, NOT BREAKING

The French economy's entry into a less robust growth phase as of mid-2004 has been confirmed by the figures for Q1 2005. The low GDP growth observed for the quarter is related in the first place to foreign trade, with French exports apparently still barely profiting from the world recovery and suffering from weak demand in nearby countries. It also results from the weakening of the re-stocking movement seen in 2004. However, the maintenance of dynamic domestic demand in the form of household consumption, house purchases and corporate investment is a major asset with a view to an upturn in the French economy. Any upturn, however, is unlikely to take place in Q2, with the latest surveys signalling no more than an easing of the ongoing deterioration in industry.

On the eve of the summer period, the euro zone's international environment, although gradually slowing down, retains a certain buoyancy. For example, the United States economy is expected to post growth of 3.4% this year, compared with 4.4% in 2004. Moreover, the easing of the euro exchange rate can be expected to strengthen the zone's capacity for export. Finally, the highly probable stabilisation of the oil price — at a high level — should lead to a gradual decline in inflation. Inflation at euro-zone level should be below 2% at the end of the year ; this moderate price rise would still justify keeping monetary conditions highly favourable.

This general picture opens up the prospect in the case of France of a return of growth in H2 to its medium-term tendency. However, given the mediocre performance in the early part of the year, 2005 is not expected to be a vintage year for growth (1.5%). The time pattern of activity will have repercussions for that of market-sector employment, which is expected to stagnate in H1 and rise very modestly in H2. The increase in market-sector dependent employment would therefore be only 30,000 in 2005. However, thanks to a surge in assisted non-market employment, especially in the second half of the year, total employment is expected to rise by roughly 130,000 in 2005. This would bring the unemployment rate down below the 10% level during the autumn (to 9.8% in December). Inflation is expected to stabilise at around 1.5% in the second half, permitting a rise in purchasing power in 2005 similar to that of 2004 and growth in consumption of a little more than 2%.

The principal uncertainty hanging over this prospect is that of a failure of growth in domestic demand to resume in France's continental neighbours. The probability of such a failure would be increased in the event of a further rise in the oil price. Indeed, the present situation of virtual saturation of productive capacity in the face of demand that shows no sign of weakening means that current prices are highly vulnerable. In the other direction, the possibility that resumption of growth in the euro zone may be underpinned by a favourable policy mix cannot be ruled out. ■

The two uncertain factors that it was feared might negatively affect the scenario set out in the March 2005 note have in the end materialised simultaneously: the oil price has remained persistently above $50/barrel and demand in France's European partners has become bogged down, hampering the incipient recovery. Although French domestic fundamentals have held up reasonably well, the deterioration in these external factors is nevertheless estimated to have brought quarterly GDP growth in the first part of 2005 to around 0.2%-0.3%, insufficient by itself to make any dent in the current inertia of the unemployment rate.

The high level of oil prices and the seizing up of domestic demand in the euro zone have put the French economy on the path of industrial recession in the early part of 2005

The persistently high oil price has adversely affected the world economic climate. In the past year, the price of Brent has been on an underlying upward trend of more than $2 per quarter and since March has been firmly anchored above $50/barrel. The worldwide industrial slowdown in the early part of this year is likely to attenuate this upward tendency. However, the determination of certain OPEC members, faced with strong demand, to keep the price between $40 and $50, together with the capacity limitations now affecting production, can be expected to keep the Brent price around $45 for the rest of the year.

The impact of the slowdown at international level that began in mid-2004 has moreover been amplified in Q1 2005 by the geographic structure of the euro zone's exports. In particular, imports into the United Kingdom, the zone's main trading partner, fell sharply, with the impact of the past monetary tightening finally bringing about a moderation in domestic demand. United Kingdom growth is expected to be more modest this year (2.1% compared with 3.1% in 2004), despite a gradual recovery.

During 2005, it is the domestic slowdown in the zone's more distant partners that is liable to hold back world trade. Asia, where the industrial slowdown has now gone on since mid-2004 (*see box « Growth in the countries of Southeast Asia ex China and Japan», page 20),* is likely once more to see activity curbed by a further bout of weakness on the part of the Japanese economy. In the case of the United States, the steady monetary tightening in a context of worries over inflation should finally come to affect employment, with growth falling to 3.4% in 2005 from 4.4% last year.

Even so, the stagnation of French exports in Q1 2005 (- 0.1%) is principally the reflection of the slowdown of domestic demand in partner countries within the zone. The zone's good growth performance (plus 0.5% in Q1 following plus 0.2% in Q4 2005) must, from this point of view, be seen in perspective.

The impressive upturn in German GDP masks two opposing phenomena, both of which are the consequences of the decline in real wages in 2004 and the continuing wage freeze in 2005. First, substantial cost-competitiveness gains were achieved by the German economy, partly explaining the strong export performance (*see special article «Exports: Ger-*

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

(at 2000 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	Q3	Q4			
GDP	(100%)	**0.4**	**-0.4**	**1.1**	**0.4**	**0.6**	**0.6**	**0.2**	**0.7**	**0.2**	**0.3**	**0.4**	**0.6**	**0.9**	**2.1**	**1.5**
Imports	(28%)	0.4	0.0	0.7	2.2	0.5	3.0	2.2	1.0	0.6	0.5	0.8	0.8	1.3	6.1	4.3
Consumption	(54%)	0.3	-0.1	1.1	0.3	1.0	0.5	-0.1	1.1	0.7	0.3	0.5	0.5	1.6	2.3	2.2
Public consumption*	(23%)	0.1	0.5	0.9	0.9	0.6	0.5	0.5	0.6	-0.4	1.0	0.5	0.7	2.1	2.7	1.6
Investment	(19%)	1.0	0.8	1.3	1.2	-0.5	0.9	-0.3	1.3	1.3	0.5	0.5	0.6	2.7	2.2	3.2
of which:																
Non financial corporated and unincorporated enterprises	(11%)	*-0.2*	*0.0*	*1.5*	*1.6*	*-0.5*	*1.2*	*-0.7*	*1.9*	*1.6*	*0.1*	*0.3*	*0.5*	*0.0*	*2.4*	*3.3*
Households	*(5%)*	*1.6*	*1.0*	*0.4*	*0.7*	*0.4*	*1.6*	*0.6*	*0.8*	*0.8*	*1.0*	*0.8*	*0.9*	*3.8*	*3.1*	*3.5*
Exports	(29%)	-1.9	-1.3	1.0	1.3	0.1	1.0	0.4	0.9	-0.1	0.5	0.6	1.0	-1.7	2.4	1.9
Contributions to growth																
Internal demand ex. inventory changes		0.4	0.2	1.1	0.6	0.6	0.6	0.0	1.0	0.5	0.5	0.5	0.6	1.9	2.4	2.2
Inventory changes		0.6	-0.3	-0.1	0.1	0.1	0.6	0.7	-0.3	-0.1	-0.2	0.0	0.0	-0.2	0.8	0.0
Net foreign trade		-0.7	-0.4	0.1	-0.2	-0.1	-0.6	-0.5	-0.1	-0.2	0.0	-0.1	0.1	-0.9	-1.0	-0.7

Forecast

* General government and NDISH's consumption expenditures
Weight in 2000 in brackets

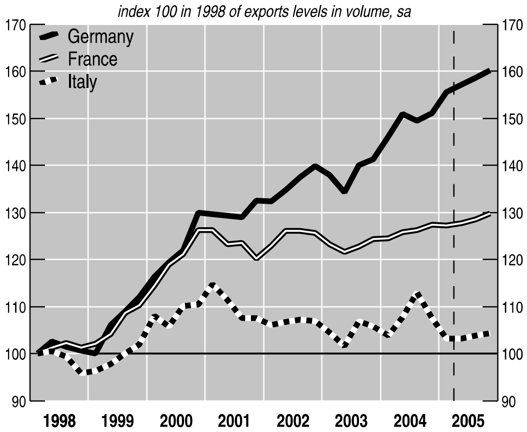
many 1 - France 0", page 9). In return, however, the purchasing power losses badly affected German household demand and it is this second phenomenon that seems to dominate firms' views of the future: the deterioration in survey results and the signs of slowdown in investment rule out any expectation there might be of an immediate rally in the German economy, the best that can be expected being a delayed consolidation.

Meanwhile, Italy has entered recession. As a result of incessant market share losses, Italian industry has been weakened by the world slowdown even more than those of its partners (*see Graph 1*). As a result, the Italian labour market and, finally, domestic demand, which had stood up well in 2004, are now collapsing.

1

COMPARATIVE ANALYSIS OF EXPORTS IN THE EURO ZONE

index 100 in 1998 of exports levels in volume, sa



sources: Destatis, Insee, Istat

forecasts after the dotted line

All in all, in coming quarters the profits accumulated last year and the relatively accommodating monetary conditions are unlikely to be sufficient to counter the gloom felt by European industrial leaders, despite the incipient recovery in the dollar against the euro. As a result, GDP growth in the euro zone will probably again decline in Q2, reaching a low of 0.2%, before picking up in H2. Euro-zone growth for the year as a whole is likely to come out at a modest 1.3% compared with 1.7% in 2004, with several countries (Italy, the Netherlands) posting virtually zero growth.

French foreign trade will probably continue to be restricted by the apathy of partner economies. Following an abrupt fall early in the year, world demand for French exports is likely to recover only very gradually. Above all, exports of manufactures will have to count on a stabilisation of the euro exchange rate at around $1.25 in the second half of the year, which would make it possible to re-establish price-competitiveness margins in trade outside the zone.

To sum up, the unexpectedly severe seizing up of exports finally got the better of the French industrial upturn in 2004, with manufacturing output posting a fall of 0.4% in the first quarter of this year.

In France, the introduction of new publicly-assisted job contracts should begin to affect unemployment levels in the second half of the year

The deterioration in the economic situation in the early part of the year has had repercussions on market-sector job creation and brought to a halt the upturn first seen in 2004. In the non-farm private sector, employment already declined slightly in Q1 and is thought to have stagnated in Q2.

The initial effects of the implementation of the measures contained in the «Plan d'urgence pour l'emploi» should be felt in the second half of the year. However, for the year as a whole market-sector job creations will probably be limited to 30,000, compared with 40,000 last year. The principal job-creating branches are likely to be the tertiary market sector and construction, while the improvement glimpsed in 2004 in manufacturing industry will probably be halted.

In these circumstances, it is mainly the build-up in the second half of the year of the mechanisms for assisted job contracts in the non-market sector that would enable total employment to rise by 128,000 in 2005 compared with 36,000 in 2004. Tertiary employment in the non-market sector is expected to rise considerably (by 99,000, compared with 1,000 in 2004)[1]. As a result of the "Plan de cohésion social", the number of people employed on a state-assisted contract can be expected to rise, notably as a result of the build-up in the numbers benefiting from the so-called Contrats d'Avenir, corresponding to 80,000 additional jobs by the end of 2005. Lastly, the implementation of the Contrat d'Accompagnement dans l'Emploi (CAE) would more than offset the number of terminations due to the ending of the predecessor "contrat-emploi-solidarité" and "contrat-emploi-consolidé" arrangements.

At the same time, the increase in the labour supply is expected to be slightly higher in 2005 than in 2004 (46,000 and 39,000, respectively). All in all, the deterioration in activity in the early part of 2005, by delaying the recovery in job creations, is unlikely to make any significant dent in the unemployment rate,

(1) This estimate is based on the assumption that 26,000 of the 80,000 additional CAE contracts announced in the «emergency employment programme» come into effect already in 2005.

which is expected to remain around 10% until the autumn before declining to 9.8% at the end of the year.

No appreciable acceleration in purchasing power in 2005 …

The pause in job creation at the beginning of 2005 means a suspension of the acceleration in income purchasing power this year. On an annual average basis, growth in real gross disposable income is expected to be 1.9%, only slightly better than in 2004.

Admittedly, in the wake of the hesitant consolidation of total employment as the year goes on, total wage earnings received by households can be expected to accelerate slightly. However, this improvement would be offset by the acceleration in the recovery of taxes paid by households following the increase in the CSG (generalised social contribution) rate as of 1 January, on top of the acceleration in the growth of the tax base carried out last year. In addition, growth in the other components of income (benefits and investment income) are set to slow down. In particular, investment income, after contributing substantially to the acceleration in disposable income in 2004, will probably level off. This would be particularly true of dividends, which cannot be expected to repeat their exceptional dynamism of last year.

Purchasing power would nevertheless be able to count on the confirmation of disinflation in the second half of the year. Inflation has already posted a substantial decline this year, falling to 1.5% in May from 2.1% in December 2004. This easing is explained mainly by the decline in the year-on-year rises in tobacco prices, as well as those in energy prices, which until April had been pushing inflation up.

In the second half of 2005, on the assumption of a Brent price of $45/barrel and a euro exchange rate of $1.25, inflation is set to stabilise, standing at 1.5% in December 2005.

… meaning that households are likely to give priority to saving and investment over consumption

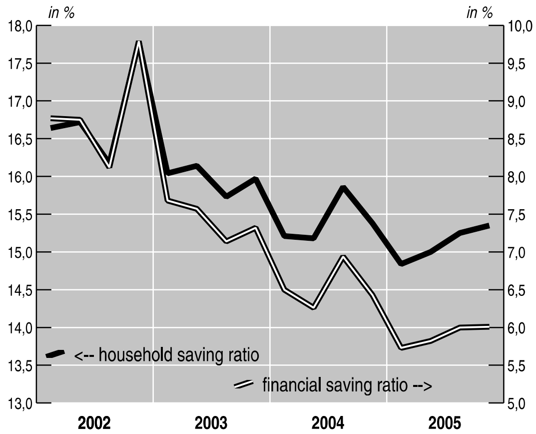
French households' behaviour has continued to differ from that of German and Italian households in Q1 2005. The decline in the saving ratio has continued, underpinning a further rise of 0.7% in consumption.

In the winter of 2004-05, household demand partially benefited from measures concerning *inter vivos* family donations and corporate savings schemes [2], the result being a decline in the saving ratio in accounting terms. The gradual petering out of the impact of these measures can be expected to bring evolutions in household consumption more into line with income purchasing power in the rest of 2005, and this would automatically mean a gradual increase in the saving ratio. As a result, household consumption can be expected to mark time in Q2 (+ 0.3%). In the second half of the year, two factors can be expected to cushion this automatic correction, namely the slowdown in inflation and the recovery in purchasing power. All things considered, annual average growth in consumption is put at 2.2% this year, accompanied by a decline of 0.3 of a point in the saving ratio.

Meanwhile, the momentum of French households' investment, unlike that seen in Germany, was maintained in the early part of 2005, underpinned by favourable financial conditions and the so-called de Robien arrangements, offering advantageous tax conditions for the acquisition of property intended as rental investment. To judge by the latest figures for housing starts, housing investment can be expected to remain firm in 2005, rising by 3.5% compared with 3.1% in 2004. The tenacious liveliness of household investment has nevertheless sent the financial saving ratio plunging to a historic low (*see Graph 2*) and this is increasing the possibility of a tendency reversal.

2

EVOLUTION OF THE SAVING RATIO
AND THE HOUSEHOLD FINANCIAL SAVING RATIO



Corporate demand likely to amplify the weakening of activity as of mid-year

Non-financial firms' GFCF in the form of construction can also be expected to maintain its momentum, driven by purchases of housing (essentially social housing) which will be boosted

(2) See the March note : "Impact of the 2004 consumption support measures", available in French only.

throughout 2005 by the build-up of the impact of the «Plan de Cohésion Sociale». Investment in manufactured goods, on the other hand, after rising in particularly dynamic fashion in the winter of 2004-05, can be expected to level off. Benefiting from the rise in demand towards the end of 2004, it has undergone a distinct improvement typical of the accelerator effects seen in periods of economic recovery. The deterioration in industry in the early part of the year should nevertheless be rapidly reflected in the pattern of investment, with GFCF growth falling to 0.1% in Q2 before returning to around 0.4% per quarter in the second half. Given the favourable state of financing conditions and, even more, the abundant liquidity derived from past earnings, the investment ratio is expected to continue to rise.

As regards inventory behaviour, on the other hand, firms are likely to respond to the weakening of demand by applying substantial corrections to the rate of stock building in Q2.

Output growth bending in H1 but not expected to break in H2

In Q1, production in all branches taken together tended to level off (+ 0.2% compared with + 0.7% in Q4 2004).

The reasons for this levelling off are to be found in the first place in the downturn in manufacturing output. The latest business surveys indicate an improvement only towards the end of Q2, with manufacturing output continuing to decline during the quarter in a time pattern imposed essentially by the adjustment in corporate demand and the parallel weakening of household demand.

In the second half of the year, however, this tendency is likely to be reversed, with the stabilisation of export outlets and the regained price-competitiveness leading to a gradual upturn in manufacturing output during H2 (+ 0.3% in Q3 followed by + 0.9% in Q4).

Another sector liable to hold back growth in activity in Q2 is energy production. After leaping by 2.0% in Q1 2005, energy output is expected to experience a downward correction before later again moving in line with the evolution in manufacturing activity and the moderate progress made in the transport sector.

Movements over time in the other sectors are likely to be smoother. The production of market services is expected to continue to show timid growth in Q2, with the business leaders in the sector questioned in the May survey reporting a deterioration in the general outlook for their sector. It will probably be necessary to wait until the second half of the year before market services find their second wind. In the case of mainly non-market services, the stagnation seen in Q1 (- 0.1% following + 0.5%) can be directly linked to the slowdown in healthcare services. A recovery is expected as of Q2 before a renewed acceleration in H2.

Finally, the construction sector is expected to remain dynamic during coming quarters, giving growth of 2.7% for the year, as in 2004. The indicators relating to both residential and non-residential housing are pointing in this direction, as are the expectations of public works entrepreneur questioned in April.

Taking the year as a whole, total output is expected to rise by 1.7%, with activity slowing distinctly in manufacturing (+ 0.7% compared with + 2.3% in 2004) but with construction, market services and distribution, by contrast, maintaining a growth rate close to that of 2004 at above 2.0%.

All in all, French GDP is estimated to rise by 1.5% in 2005, following 2.1% in 2004 (2.3% excluding the adjustment for the number of working days), but its pattern over time would feature a gradual upturn in the second half: following growth still restricted to 0.3% in Q2, GDP would then rise by 0.4% in Q3 and 0.6% in Q4.

This forecast is subject to two main uncertainties. A further surge in the oil price could act as an additional handicap on the consolidation of France's European partner economies and this would impose a distinct curb on French activity. In the other direction, it is not impossible that a macroeconomic policy applied at European level might provide support for recovery of domestic demand in the zone. ■

Box: impact of a modification in the exchange-rate assumption

The whole of the forecast set out in this Note is based on the assumption of a euro exchange rate of $1.25 in the second half of 2005. It is worth recalling that, in relation to this baseline scenario, a fall of 10% in the euro as of Q3 would procure additional export growth for France in 2005 amounting to roughly one half of a point. This in turn would raise annual GDP growth by 0.1 of a point, while inflation would stand 0.1 of a point higher at the end of the year. ■