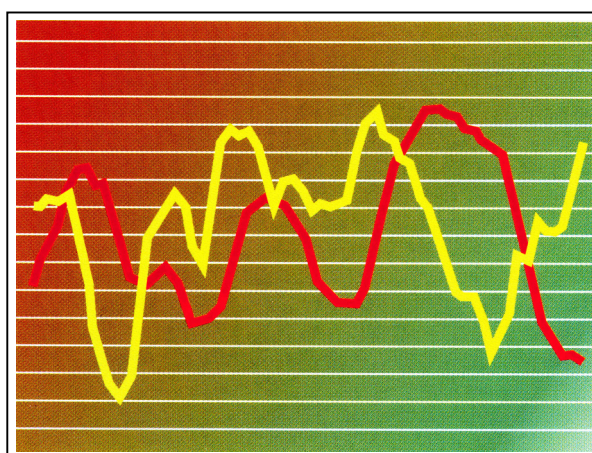


# CONJONCTURE IN FRANCE

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**MARCH 2006**



**THE ENVIRONMENT REMAINS BUOYANT**

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## THE ENVIRONMENT REMAINS BUOYANT

**T**he modest level of French growth in Q4 2005, held down by a decline in manufacturing output, notably of cars, has served to emphasise the fragility of activity in industry. Admittedly, this sector is the one most concerned by the difficulties facing French foreign trade. For the second consecutive year, foreign trade in accounting terms reduced annual growth by one percentage point, with the rise in exports (3.2%) remaining below that of world demand while at the same time imports were rising strongly (by 6.6%). This meant that growth in 2005, which was also hit by a decline in agricultural production, was not as great as in 2004. And yet domestic demand barely weakened. Corporate investment rose by 3.7%, investment by households rose by 3.1% and, above all, household consumption remained the main driving force for growth with a rise of 2.1%. This latter tendency was helped by a steady decline in the unemployment rate, which was down to 9.6% at the end of the year from 10% at the end of 2004, and by a steady rise in market-sector dependent employment (50,000 additional jobs). It was also helped by the subdued level of inflation: consumer prices rose by only 1.5% in 2005, despite the surge in oil prices.

The international environment is still buoyant in the early part of 2006, with growth remaining brisk in both the United States and in Asia. The euro zone is benefiting from this, with the past steep rise in the euro exchange rate now mainly a thing of the past. The euro exchange rate is now in fact stable in the vicinity of \$1.20. Markets in both the euro zone and the United States are expecting further rises in key rates, but the impact of this tightening is still limited, notably because long rates have been rising only very slightly. Business surveys in the euro zone are accordingly pointing to lively activity, with the improvement in the business climate particu-

larly noticeable in the case of Germany. Growing export order books can be expected to generate an acceleration in French exports, despite the difficulties of adjusting to the structure of world demand. At the same time, French household consumption is expected to continue to increase. With the saving ratio tending to stabilise, this increase would be based on a rise in purchasing power, benefiting from the easing of inflation. The year-on-year price rise, following a spike in January, is expected to fall back to 1.6% in June. Mainly under the impact of the rise in interest rates, demand for housing is likely to start to level off, but growth in activity in the building sector should remain strong, in view of the very large number of starts in the final months of 2005. As a consequence, GDP is expected to show annualised growth of slightly more than 2% in the first half of 2006. Imports are likely to continue on a firm upward trend (6%, annualised) but not quite as fast as at the end of last year. Market-sector dependent employment, feeling the effects in Q1 of the weakness of growth towards the end of 2005, is expected to rise by 25,000 in H1 2006. However, with the inclusion of non-market employment, notably in the form of assisted contracts, total employment is likely to rise by roughly 110,000 during this period. Combined with the trend slowdown in labour force growth, this increase would permit a further decline in the unemployment rate (to 9.2% in June).

One uncertainty with positive potential hanging over these prospects is the possibility of a more vigorous upturn in the German economy, in line with the considerable optimism currently being displayed by German firms. In the other direction, the strength of the world economy is maintaining the threat of further surges in the prices of oil and other raw materials. ■

*In France, while the results for Q4 2005 have again confirmed the robustness of household and corporate demand, they have also shown the danger lying in the fact that the respective lags vis-à-vis domestic demand in other European countries may turn out to be more beneficial to imports than to domestic production. Despite the difficulties surrounding both sides of foreign trade, growth in French activity, after slowing in 2005, is expected to settle down in the early part of 2006 at an annualised rate of slightly more than 2.0%.*

### Brisk growth in the world economy, but containing persistent imbalances

The fluctuation range for the oil price has for several weeks been centred on \$60/barrel, following the trend rise in the Brent price amounting to \$3 per quarter since 2003. Short-term evolutions in the oil price are more than ever dependent on the various crises currently affecting the market. However, in view of the latest observed quotations and expectations that supply will be able, a priori, to meet demand, stabilisation of the price at \$60 has been adopted as the assumption for the whole of the forecast period<sup>(1)</sup>. On top of these pressures, there have recently been strong rises in the prices of other raw materials, not only petroleum derivatives but also metals. In these circumstances, producer prices have been rising appreciably since mid-2005 in most

of the industrialised countries, accompanying the increase in the oil bill, which in the French case has risen from 2.1 GDP points in 2004 to 2.6 points in 2005.

Even so, growth in the world economy is expected to remain brisk in H1 2006. The firmness of the outlook for activity in all regions of the world is confirmation that the consequences of the rise in oil prices, while tangible, are turning out to be contained at the present stage. In particular, competitive pressures are likely to limit the risk of any generalised increase in inflation.

In the absence of second-round effects from the oil shock, it would be logical for financing conditions to remain globally attractive. Between now and mid-2006, further interest rate hikes are expected by markets on both sides of the Atlantic. Nevertheless, in line with what has been seen so far, long-term interest rates are likely to remain relatively unaffected by increases in key rates until the middle of the year (see the special article on page 11: "Should we be afraid of the weakness of long-term bond rates?")

The general climate may be favourable, but divergences in performance between industrialised countries are expected to persist. This tendency is likely to generate even greater leads and lags in the evolution of external balances, in a way that is hardly consistent with the considerable inertia shown by currency markets in recent months<sup>(2)</sup>.

Domestic demand in the United States and, to a smaller extent, in Japan and the United Kingdom can be expected to continue to contrast with that expected in the euro zone. These differences are likely to be mainly due to divergences in the momentum

(1) Or averages of \$61 and \$60, respectively, in Q1 and Q2 2006.  
(2) The euro/dollar exchange rate is assumed to be stable at 1.20 for the whole of the period of the forecast, very close to its present level.

### 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			
<b>GDP</b>	(100%)	0.5	0.7	0.0	0.7	0.3	0.0	0.7	0.2	0.6	0.5	2.1	1.4	1.5
Imports	(28%)	0.6	3.6	1.7	1.0	0.9	1.4	2.7	2.4	1.6	1.5	6.1	6.6	6.4
Consumption	(54%)	0.7	0.8	-0.2	1.3	0.6	-0.2	0.7	0.7	0.7	0.6	2.3	2.1	2.0
Public consumption*	(24%)	0.7	0.8	-0.0	0.6	0.0	0.2	1.2	0.4	0.5	0.6	2.7	1.5	1.8
Investment	(19%)	-0.4	1.1	-0.4	1.3	1.5	0.0	1.1	0.7	0.6	0.9	2.1	3.3	2.3
<i>of which:</i>														
Non financial corporated and unincorporated enterprises	(11%)	-0.4	1.4	-0.8	1.7	2.0	-0.6	1.4	1.0	0.5	1.0	2.4	3.7	2.5
Households	(5%)	0.4	1.6	0.5	0.8	0.7	1.1	0.4	0.5	0.8	0.9	3.1	3.1	2.3
Exports	(29%)	-0.1	1.2	-0.0	1.1	-0.5	1.0	3.2	0.9	1.8	1.3	2.2	3.2	5.4
<b>Contributions to growth</b>														
Internal demand ex. inventory changes		0.5	0.8	-0.2	1.1	0.6	-0.0	0.9	0.6	0.6	0.6	2.3	2.2	2.0
Inventory changes		0.3	0.6	0.7	-0.5	0.0	0.2	-0.3	0.1	-0.1	-0.0	0.8	0.2	-0.1
Net foreign trade		-0.2	-0.7	-0.5	0.0	-0.4	-0.2	0.1	-0.5	0.0	-0.1	-1.1	-1.0	-0.4

Forecast

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

shown by real incomes and, more marginally, in the amplitude of investment cycles. In particular, domestic demand in the United States, Japan and United Kingdom is expected to strengthen still further. In these three countries, job creation is set to intensify and wage momentum to be maintained, permitting an acceleration in wage growth. This environment would be favourable to investment, especially as business leaders' expectations regarding exports also remain generally positive. All things considered, annualised growth rates are expected to be 4.2% in the United States, 3.0% in Japan and 2.2% in the United Kingdom in H1 2006.

### Disparate evolutions in individual the euro-zone countries likely to start to narrow

In the euro zone, the results for Q4 2005 attest to the fragility of the upturn that began in mid-year, pending the consolidation of the domestic determinants of growth. Industrial production has slowed down, eroded by hesitant external demand and a decline in household consumption (by 0.2%), further accentuating the industrial leads and lags within the zone. While industrial production was declining in France and Italy, in Germany it was rebounding strongly. Even so, the weakness of German domestic demand continued to win out over strong export performance and the collapse in household consumption led to stagnation of activity.

In the early months of 2006, industrial surveys have been showing a significant improvement in the euro-zone business climate. Disparities between national growth rates are expected to narrow gradually. In particular, German GDP growth is expected to be at the same rate as for the zone as a whole, thanks to the upturn in construction and to the one-off boost to consumption provided by the football World Cup. In Italy, growth is expected to lag slightly behind (*see box on page 36: "Can we detect a cyclical gap between the industries of the euro-zone's major countries since 2005?"*).

Private consumption in the euro zone is expected to pick up but its underlying fundamentals are likely to remain weak, mainly because of the German situation. The moderate upturn in employment and the stagnation of wages in real terms are likely to mean slack household income growth. On the other hand, inflation can be expected to ease in H1 2006 (to 2.1% in June from 2.2% in December 2005).

Any marked upturn in the investment cycle remains subject to overall evolutions in the euro zone's external trade. The strong German performance is currently being offset by a slow deterioration in the French and Italian positions. All in all, GDP growth is expected to reach 0.5% per quarter, with the statistical carryover in mid-year 1.6%.

### French industrial production running up against uncertainties surrounding foreign trade

The modest scale of French GDP growth in Q4 2005 (0.2%) stemmed mainly from the stagnation of industrial production — with a sharp decline in the automobile sector — related both to the increased penetration of imports of manufactured products and to the fragility of exports.

Uncertainties regarding the capacity of French foreign trade to stand up to competition, against a background of lasting market-share gains by its principal trading partner (Germany), have intensified in the past year. Growth in manufacturing exports was relatively disappointing, being 2.3% on an annual average basis, despite robust world demand (up 5.5% on average compared with 2004) and a small depreciation of the euro. The erosion of market share is particularly noticeable for sales of cars and intermediate goods, immediately reflected in a stagnation of output in these two branches (*see box on page 116 "Retour sur la conjoncture de l'industrie automobile française", available in the French version only*).

Even though French exporters are unlikely to make up all their market share losses, the early part of 2006 should see a distinct upturn in manufacturing exports (2.5% growth in Q1 and 1.6% in Q2) on the back of more favourable European demand. Even so, the tenacious expansion of manufacturing imports (annual average growth of 7.5% in 2005) is likely to counter the support given to growth by foreign trade.

The liveliness of purchases of foreign goods stems in part from the orientation of demand towards goods with a high import content, such as electrical and electronic goods, clothing and certain capital goods. Moreover, the rise in imports in 2005 was stimulated by price evolutions that were unfavourable to France (*see box on page 9: "Possible interpretation of the strength of manufacturing imports in 2005"*). In the early part of 2006, the greater investment restraint shown by firms should temporarily slow growth of imports of manufactured products to around 2.0% per quarter. Even so, the statistical carryover for manufacturing import growth in mid-year would already amount to 8.5%.

### Firms remaining circumspect regarding their investment prospects

The gloom in the industrial sector seems to be leading firms to defer certain investment programmes. Corporate investment is expected to slow down slightly in Q1 2006 (growth of 0.5% for the period) following the strong upturn seen in H2 2005. In H2 2006, capital spending is expected to return to aver-



age growth, under the influence of continuing favourable financing conditions and slightly greater pressure on productive capacity. As a result, the recent strengthening of investment in construction and public works would be confirmed. However, growth in total investment would remain well below what it was at the end of the 1990s.

Above all, difficulties in the industrial sector are also affecting firms' inventory behaviour. In particular, firms in the automobile sector carried out massive de-stocking in Q4 2005. According to business surveys, stocks of cars are seen as being more excessive than for industry as a whole. A slightly negative contribution from inventories can therefore again be expected in the early part of 2006.

Growth in overall employment at the end of H1 2006 is likely to be driven by the build-up of assisted employment contracts, bringing the unemployment rate back down to 9.2% in mid-year.

The troubles of the industrial sector are having only a minor influence on the labour market. The decline in the unemployment rate in 2005 (to 9.6% in December from 10.1% in January) has accompanied growth in overall employment amounting to 85,000 jobs for 2005 as a whole. The first half of 2006 should see overall employment continuing to accelerate, with roughly 110,000 additional jobs. This acceleration would be mainly due to the increase in the number of beneficiaries of assisted contracts in the non-market sector, while the other sectors of activity would post a growth rate very similar to that of 2005.

Dependent employment in the non-farm market sectors accelerated slightly in 2005 (50,000 additional jobs), despite the hectic economic climate. The early part of 2006 is likely to see dependent job creations continuing at much the same rate as in the last part of 2005, with net job creations amounting to around 25,000 in the first six months.

At the same time, the increase in the supply of labour is expected to be much the same in 2006 as in 2005: an addition of 42,000 in 2005 and 19,000 in H1 2006. As a result, the unemployment rate according to the ILO definition would continue to decline, reaching 9.2% at the end of June 2006.

### **A gradual upward tendency in household purchasing power ...**

With the upturn in employment still timid, it is wage movements and the slowdown in prices that are bringing about a moderate but steady acceleration in purchasing power of household disposable income, which rose by 1.8% in 2005 compared with 1.6% in 2004, with the statistical carryover in mid-year already amounting to 2.1%.

The first half of 2006 is in fact likely to see all the various components of income moving in the same direction: taxes paid by households moving less quickly, dividends accelerating, for example. Earned income should continue to be driven by average wages per head while the recovery in the gross operating surplus of individual entrepreneur should continue.

Moreover, with movements in energy prices continuing to dictate the pattern of inflation, the year-on-year change in the overall index is likely to decline following an early part of the year marked by the unfavourable combination of an upturn in energy prices and a base effect as a consequence of the exceptional declines recorded in January 2005. Inflation is expected to stand at 1.6% in June 2006.

### **... establishing firm rates of growth for household consumption and investment**

The erratic time-pattern of household expenditure is gradually being smoothed out. The correction expected in Q4 2005 in fact failed to materialise and household consumption expenditure rose by 0.7% in the quarter, as in Q3, with the growth rate of spending on services higher than that of spending on goods. In the first part of 2006, growth in household consumption is likely to have tracked that of purchasing power, at around 0.7% per quarter.

On top of this firmness of private demand there is likely to be an upturn in so-called "individualisable" government expenditure, i.e. public spending on items such as healthcare or education for the benefit of individuals rather than society at large.

Another likely accelerating factor is that the latest figures for housing starts suggest that investment in housing can be expected in the first two quarters of 2006 to regain the dynamism it showed in H1 2005, giving growth rates of 0.8% in Q1 and 0.9% in Q2.

### **The three faces of the French economy: fragile industry, buoyant distribution and services and robust construction**

In Q4 2005, output from all branches again flagged (+0.2% compared with +0.7%), as the result of the 0.5% decline in manufacturing. This decline was surprising, given the generally positive signals coming out of the business surveys: the composite business climate index had shown a virtually uninterrupted rise since the beginning of H2 2005, while the turning-point indicator had been pointing to an upswing. This discrepancy between business survey results and actual performance makes it hazardous to use the usual instruments. Nevertheless,

the expected improvement in foreign trade is pointing to an upturn in manufacturing output amounting to 0.9% in Q1, preceding a return to 0.5% thereafter.

Moreover, activity in the non-industrial branches is expected to show distinct firmness. Output in distribution should benefit from the liveliness of household consumption, growing at quarterly rates of the order of 0.7% to 0.9%. For the same reasons, output of market services is expected to show constant growth of the order of 0.6% per quarter. Also, a fresh acceleration in construction is expected (*see the special article on page 17 "Analyse de la conjoncture du bâtiment depuis 1980 et construction d'un indicateur de retournement", available in the*

*French version only*), linked to the persistent strong demand from households and the expected revival of public works.

The agricultural sector is liable to be affected by the disturbances linked to bird flu, but the overall impact is likely to be very small (*see the box on page 114: "Une première estimation des effets économiques de la grippe aviaire en France (cantonnée aux animaux)", available in the French version only*).

All in all, output from all branches is expected to show greater dynamism in the early part of the year, rising at quarterly rates of 0.7% until mid-2006. Quarterly GDP growth should return to 0.6% in Q1 2006 and then 0.5% in Q2, giving a statistical carry-over of 1.5% in mid-year. ■

## BOX: Possible interpretation of the strength of manufacturing imports in 2005

The initial quarterly accounts figures for Q4 2005 indicate a very steep rise in French imports of manufactured products last year, with average annual growth of 7.5% (compared with 6.9% in 2004) and 7% growth between the two second halves.

This substantial expansion of imports, combined with the relative weakness of exports, resulted in a negative contribution from foreign trade to GDP growth amounting to 1.0 percentage point compared with 1.1 points in 2004.

These evolutions took place at a time when French manufacturing output had for a year been going through a phase of weakness, even showing an actual decline of 0.5% in Q4 2005. However, this interpretation would not seem to be borne out by the empirical elements available.

**In 2005, it was only the import content of corporate demand that showed a significant increase, with the import content of final demand unaffected.**

The strength of imports seen last year may have been the result of the particular role played by just one of the items of final demand. The link between imports and domestic demand for manufactured products is liable to depend to a great extent on the type of demand being considered, whether emanating from households or firms, for example. In order to explore this possibility, the import contents of various items of final demand were evaluated, distinguishing the contribution of each institutional sector (see Graph 1).

Contrary to what might intuitively be expected, there does not seem to have been any particular shift in the import content of overall final demand. A more detailed examination shows that only the import content of corporate demand rose significantly (from 27.7% in 2004 to 29.9% in 2005). No similar significant increase is to be seen in the case of demand from households or for exports.

This indicates that the acceleration in demand from firms for capital goods and intermediate goods was the main reason for the liveliness of imports in 2005.

**A traditional modelling of imports of manufactured products shows no abnormally great evolution in 2005**

The absence of singularity in the evolution of imports in 2005 suggested by the stability of the import content of overall demand seems to be corroborated by a model of the evolution of imports of manufactured products using the traditional determinants.

In particular, the combination of brisk domestic demand, price-competitiveness losses on the domestic market and the trend towards greater openness of markets accounts for at least 6% of the growth in imports of manufactured products in 2005.

Above all, the model highlights the influence of price-competitiveness losses on the domestic market on growth in manufacturing imports since 2001.

**The overall loss of price-competitiveness vis-à-vis imports in the case of France, which is a persistent trend but showing wide contrasts between sectors, may be due to a large number of factors.**

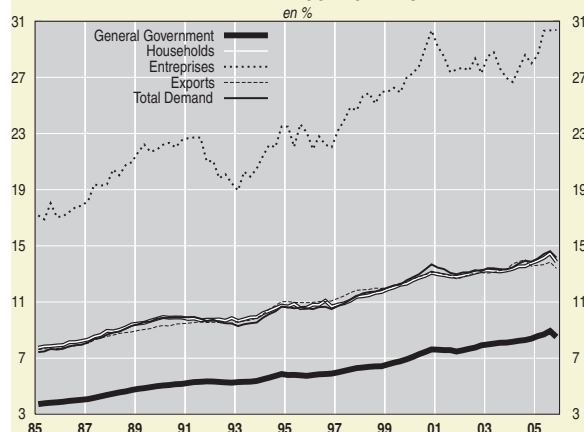
Price-competitiveness losses vis-à-vis imports have in fact been recorded for five years now. The ratio between import prices and domestic demand prices has been declining by roughly 2.5% per year. These price-competitiveness losses appear to have contributed, on average, 1.6 percentage points per year to the growth of manufacturing imports since 2000.

**Even so, no acceleration in this phenomenon was perceptible in 2005.** Price-competitiveness losses to imports were indeed high, but were in line with the trend over the past five years.

The evolution in import price-competitiveness nevertheless turns out to show wide contrasts between individual manufacturing sub-branches. For example, the automobile sector seems rather to have tended to show improved import price-competitiveness in the past five years — in

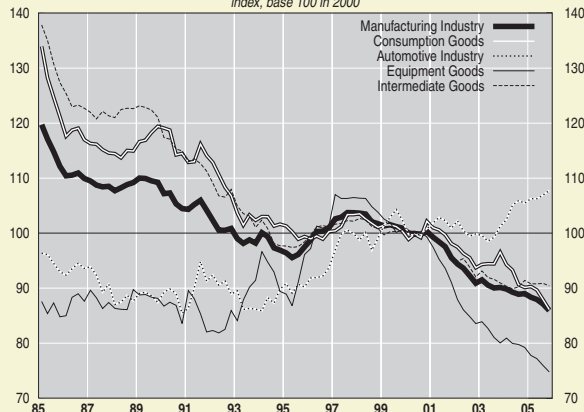
1

MANUFACTURING IMPORT CONTENT OF FINAL DEMAND COMPONENTS



2

CHANGE IN IMPORT COMPETITIVENESS





other words, domestic prices in this sector seem to have moved less rapidly than import prices. By contrast, import price-competitiveness losses for capital goods have been twice as rapid as for manufacturing as a whole. The losses in the case of consumer goods seem to have been in line with the average tendency.

However, no simple interpretation of these import price-competitiveness losses is possible. They may show either the limitations of the statistical measurement of foreign trade prices, or the impact of the structure of demand

for French imports (shift in favour of products that are not manufactured on a large-scale in France) or, more problematically, an unfavourable evolution in French cost-competitiveness.

All things considered, therefore, and despite the apparent price-competitiveness of losses, **it is not possible at this stage to conclude that there has been a direct substitution of imported foreign products for French products.** ■