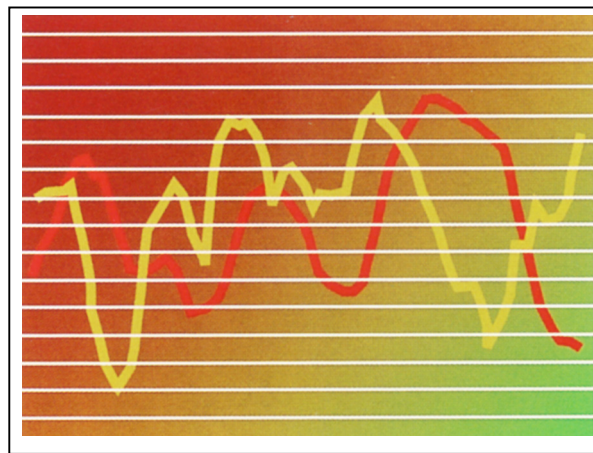


CONJONCTURE IN FRANCE

MARCH 2007



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MILD WINTER, MILD GROWTH

Mild winter, mild growth

As expected, France's international environment has become less buoyant in early 2007. The U.S. economy is still hampered by the real-estate market drop and is projected to continue growing at below potential in H1 2007. Germany's VAT hike entailed, as forecast, a sizable fall in consumption at the start of 2007, which will slow the German economy at least temporarily.

However, some world growth drivers are still very much at work. The uptrend in oil prices ceased in summer 2006, and the easing of tensions on the physical market may even send oil prices down after the end of the North American cold wave.

This subdued behavior of oil prices sustains real household income and corporate profits. It should thus keep the U.S. slowdown within moderate proportions. It has even promoted an economic recovery in South-East Asia.

Domestic demand in the euro zone, which consistently surprised analysts in 2006 by exceeding forecasts, now seems well into a cyclical rebound, which should enable it to cushion the impact of German and Italian fiscal tightening.

All in all, the world economy should experience no more than a mild slowdown in H1 2007.

The French economy remains capable of withstanding this international slowdown, as witnessed by the persistently favorable outlook in business surveys. Growth is expected to range between approximately 0.5% and 0.6% per quarter, with the mild winter exerting a slightly negative effect in Q1 but, conversely, a positive effect in Q2.

French exports are projected to register a moderate increase, due to weaker growth among a number of our economic partners, but domestic demand should hold firm.

In fact, consumption is likely to remain a growth engine. The improved labor market, which is driving up wage earnings, the tax cuts scheduled for 2007, and the easing of inflation are all sustaining real personal income. After stabilizing in 2006, the household saving rate is even expected to rise slightly in 2007, without breaking the consumption momentum.

The French productive capacity utilization rate is close to its medium-term level, which means that business investment should continue to grow in step with the economy.

As a result, job creations are forecast to continue at a robust pace, totaling about 110,000 in H1.

The main downward risk for the global economy is the U.S. real-estate market. The signals remain contradictory and do not allow an exact prediction of when the market drop will end. Apart, perhaps, from their contribution to the abrupt rise in risk premiums on the financial markets in early March, the contagion effects on the rest of the U.S. economy are not yet visible, and whether they will materialize remains an open question. Conversely, the euro zone's potential for a cyclical rebound—already underestimated in 2006—could be understated again in 2007. ■

Quarterly fluctuations aside, the French economy has been expanding at a steady annual trend of about 2% for a year and a half. In fact, this is its annual average growth for 2006. In H1 2007, the economy is forecast to expand at slightly above that rate. France should also continue to display a different profile from other euro-zone members: while driven by a stronger domestic demand than that of its partners, France is not expected to match their external performance.

A weaker international environment ahead for the euro zone

For the industrialized regions as a whole, Q4 2006 turned out to be more buoyant than expected. In the euro zone and the United Kingdom, growth was somewhat more vibrant than forecast, and even the Japanese economy displayed surprising vigor notwithstanding its slow exit from deflation.

Despite this more upbeat climate, we maintain our forecast of a decelerating international environment to mid-2007, albeit with slight qualifications. After four years of outstanding growth, a global loss of momentum is now visible, in the wake of the U.S. economic performance and as a result of the monetary tightening enacted in most regions for over a year now. Business surveys in manufacturing, for example, are less positive than in spring 2006. This deterioration suggests that world industrial production will be slightly less buoyant than a year ago.

However, the more sluggish global context may have a positive consequence that could curtail the economic slowdown: the overall weakening of demand in the commodity markets would allow oil prices to stabilize at about \$55/barrel. The easing of energy inflation may loosen corporate profitability constraints and sustain domestic demand in consumer countries. High-growth emerging countries such as China and India could thus maintain vigorous expansion rates. With the end of monetary-policy tightening and commodity-price rises, South-East Asia actually seems poised for a rebound.

In sum, at the start of 2007, OECD countries seem to be the main cause of the less vibrant climate. More specifically, in the United States, the effect of the real-estate market downswing on economic growth is expected to persist in early 2007. However, the end of the cycle of key-rate hikes and the resilience of personal consumption, powered by robust gains in real income, should sustain the economy. The forecast decline in U.S. growth should therefore be modest. In Japan, the economy is likely to grow more moderately than at the very end of 2006, as domestic demand is cramped by the lack of a clearcut exit from deflation. The Bank of Japan's latest rate hike in February could therefore be somewhat premature. The industrialized economy that should prove most resilient in early 2007 is that of the United Kingdom, with households continuing to benefit from positive labor-market conditions and real-estate wealth effects.

France: supply and use table (in real terms)

at 2000 prices, seasonally and working-day adjusted, quarterly and annual changes, %

		2005				2006				2007		2005	2006	2007 ovhg*
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
GDP	(100%)	0.2	-0.1	0.7	0.2	0.5	1.1	0.0	0.6	0.5	0.6	1.2	2.0	1.7
Imports	(28%)	0.9	0.9	2.6	3.2	0.9	3.2	-0.6	0.3	0.8	1.1	6.4	7.1	2.4
Household consumption	(54%)	0.5	0.0	0.9	0.6	0.9	0.7	0.6	0.4	0.7	0.9	2.2	2.7	2.2
Public consumption**	(24%)	0.1	0.0	0.6	0.0	0.6	0.6	0.4	0.5	0.5	0.5	0.9	1.6	1.6
Total investment***	(19%)	1.1	0.4	1.8	0.7	0.3	1.4	0.6	1.1	0.8	0.6	3.7	3.5	2.7
of which:														
Non-financial incorporated and unincorp. enterprises	(11%)	1.0	-0.2	2.3	0.8	-0.1	1.8	0.8	1.1	0.9	0.7	3.8	3.8	3.2
Households	(5%)	0.7	1.4	0.5	0.7	0.6	0.5	0.4	0.3	0.4	0.3	4.1	2.5	1.2
Exports	(29%)	-0.6	0.3	3.5	0.7	3.0	1.4	-1.3	1.2	0.3	0.6	3.2	6.2	1.4
Contributions to growth														
Domestic demand excl. change in inventories		0.5	0.1	1.0	0.5	0.7	0.8	0.6	0.6	0.7	0.8	2.2	2.7	2.2
Change in inventories		0.1	0.0	-0.5	0.5	-0.9	0.9	-0.3	-0.2	0.0	0.0	0.0	-0.3	-0.1
Net foreign trade		-0.4	-0.2	0.2	-0.8	0.6	-0.6	-0.2	0.3	-0.2	-0.2	-0.9	-0.4	-0.3

Forecast - Weights in 2000 in parentheses

*ovhg: statistical overhang, i.e., annual change if variable in question was to remain at its level in the last known quarter. The overhang measures the impact of past changes; it is not a forecast.

**Expenditures by general government and non-profit institutions serving households (NPISHs)

***Gross fixed capital consumption (GFCF)

Source: INSEE

Overall, economic activity in the main industrialized regions should decline in sync, sending the annual average growth rate to just over 2.0% by mid-2007 after nearly 3.0% in 2006.

The euro-zone recovery, clearly under way in 2006, should be temporarily slowed by fiscal tightening in early 2007

With an annual growth of 2.8% in 2006, the euro zone has pulled out of the soft-growth phase that had prevailed since 2000. Economic activity quickened in all countries of the region—particularly Germany, which stopped lagging its partners in 2006.

The recovery was further strengthened by the Q4 gain of 0.9%, fueled by investment and foreign trade, whereas consumption received only a modest boost from German household purchases ahead of the January 2007 VAT hike. The remarkably sharp export rebound consisted of sales to non-OECD partner countries such as China, Russia, and—more unusually—Switzerland (Chart 1).

In early 2007, the German and Italian tax increases should weigh on domestic demand in both countries, dragging down euro-zone growth to 0.4% in Q1 and 0.6% in Q2. A weaker international environment for the euro zone is also likely to dampen the external stimulus, but the domestic drivers—labor market and investment—should nevertheless continue to prevail, bringing the statistical overhang for euro-zone growth to 2.0% by the end of H1.

French exports should rise at a moderate pace, keeping industrial production on a still fragile growth path

French exports of goods and services grew 6.2% in 2006, or at nearly twice the pace recorded in 2005 (3.2%). Germany's economic upswing last year partly explains the vibrancy of external demand, which is responsible for this rebound. While France continued to lose market share, the phenomenon was more limited than in previous years. Given the less favorable environment, the growth of French manufactured exports should level off to 0.6% in Q1 and 0.8% in Q2.

Despite this robust export growth, French manufacturing output posted another disappointing figure in Q4 2006: its stabilization, after a sharp decline in summer, reflected persistent difficulties in the automotive industry, but also more recent problems in aeronautics. Although business surveys indicate a high level of confidence among manufacturing executives, there are no current

signs of a significant improvement. Manufacturing output is accordingly forecast to register modest gains of 0.3-0.4% per quarter in early 2007.

Amid this despondent climate in the goods-producing industries, domestic demand continues to be largely met by manufactured imports, which are still rising briskly. Their annual average growth in 2006 came to 9.4%, despite a loss of momentum at year-end probably due to stalled investment demand. Household consumption should, however, continue to drive import growth in Q1 and Q2 2007, generating increases of 0.8% and 1.1% respectively.

Still many job creations in early 2007

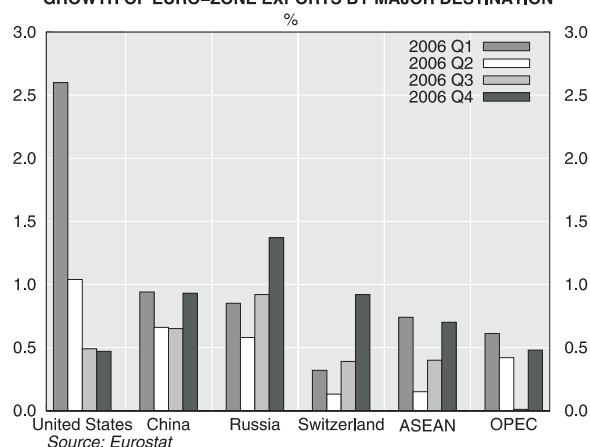
The French economy created a total 252,000 jobs in 2006. The increase was largely fueled by the growth in payroll employment in the market sector, which added 192,000 jobs in 2006 after 117,000 in 2005. Employment also benefited from a sharp increase in non-market sectors, where the number of subsidized jobs rose.

In 2007, this growth rate is expected to persist, with a total of about 110,000 new jobs created in H1. The market sector should create 100,000 payroll jobs; in non-market sectors, subsidized employment is forecast to remain nearly stable as the Social Cohesion Plan reaches cruising speed.

The unemployment rate should accordingly continue to decline in June, beyond the greater-than-usual uncertainties surrounding its level and the short-term change in the active population: we expect unemployment to reach 8.2% in June.¹

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GROWTH OF EURO-ZONE EXPORTS BY MAJOR DESTINATION



1. Before the statistical recalibration to be performed in fall 2007.

Real household income set to accelerate again, with inflation easing to 0.9% by mid-2007

Four factors have placed the real gross disposable income (GDI) of French households on a positive slope since 2005.

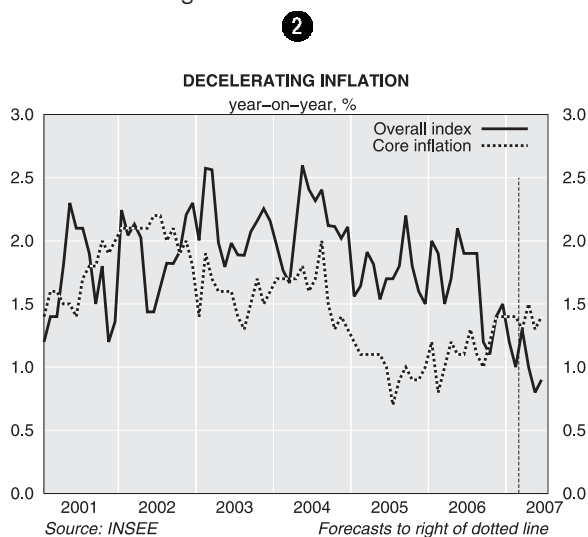
The main driver is wages and salaries, which are accelerating steadily under the impulse of growth in employment and per-capita wages. After gaining 3.3% in 2006, growth in per-capita wages in the non-farm private sector is projected to display a statistical overhang of 2.5% by mid-2007. The other income components have remained buoyant as well. This is particularly true of earnings by unincorporated enterprises, whose vibrant growth—already observed in 2006—has persisted in early 2007 thanks to the still positive climate in the construction, retail, and building industries. In early 2007, households should also benefit from a sharp slowdown in income-tax growth with the initial impact of the change in income-tax brackets and the increase in the earned-income tax credit.

Lastly, the easing of inflation is playing a major role in the profile of French households' real GDI. Year-on-year inflation is expected to fall to 0.9% by June 2007, largely thanks to energy disinflation (Chart 2).

Overall, after gaining 2.7% in 2006, real GDI is forecast to register a growth overhang of 3.0% by mid-2007.

Household consumption remains the engine of French growth

French household consumption rose 2.7% in 2006, its largest gain in six years. This average growth, in line with that of households' real GDI (2.7%), incorporates a 4.2% surge in spending on manufactured goods.



The mild deceleration in quarterly consumption growth to 0.4% in Q4 2006 is largely due to energy consumption and mild weather. The phenomenon is thus unlikely to upset the consumption-expenditures scenario for the months ahead. In H1 2007, the aggregate is forecast to grow 0.7-0.9% per quarter, with the persistence of a still vigorous manufactured-goods component.

By contrast, the initial signs of a gradual slowing of household investment have been confirmed. The latest available data on housing starts suggest that the trend may last until summer, amid a gradual tightening of financing conditions. We therefore expect household investment to rise by 0.3-0.4% per quarter in H1 2007.

By contrast, investment is expected to post moderate growth

As in 2005, business investment grew 3.8% in 2006. The acceleration in building investment and, more significantly, in civil engineering at year-end offset the smaller contribution of other equipment expenditures compared with 2005.

In H1 2007, however, firms may display greater caution in their investment decisions. Despite a recovery in outlays on manufactured equipment, business investment is expected to rise by only 0.9% in Q1, with a further mild slowdown to 0.7% in Q2.

A GDP growth profile disrupted by weather patterns

After a stagnant summer, all-industry output rose 0.6% in Q4 thanks to a marked acceleration in civil engineering, stable manufacturing production, and a rebound in household consumption of recreational, cultural, and sports activities, as well as of hotel and restaurant services after a rather unusual slippage. By contrast, energy production dropped 2.4% owing to the very mild weather in the fall.

The persistence of unseasonably clement temperatures in Q1 2007 would drive down energy production by a further 0.8% before a return to normal in Q2, automatically entailing a sharp upward adjustment. However, in our scenario, total production will continue to grow thanks to retailing (up 0.7% per quarter) and market services (up 0.6-0.8% per quarter)—boosted by domestic demand—whereas industrial production will still lag.

The construction sector is expected to record a modest downturn, consistent with household-demand patterns and the gradual decline in civil-engineering orders.

In sum, all-industry output is projected to gain 0.6% in both Q1 and Q2 2007.

French GDP growth is forecast at 0.5% in Q1 and 0.6% in Q2, its profile being somewhat disrupted by weather phenomena. We thus estimate the growth overhang by mid-2007 at 1.7%. ■