Mixed economic results for 2006

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In December 2005, we believed that the main positive factor for the French economy was domestic demand. We were wrong, since the greatest surprise of 2006 was unquestionably a far more favorable international environment for our economy than in the previous five years. Clearly, the French economy cannot perform with quite the same vitality in a euro zone stuck at 1.5% growth and in a vibrant euro zone expanding by 2.8%. The first cause of the acceleration between 2005 and 2006 is the upswing in Germany, our main partner. Other causes were the lack of "second-round" effects from the oil shock (despite its magnitude, with the barrel price climbing from \$35 to \$65 in two years) and, no doubt, the halt in the euro's appreciation.

Yet our economy failed to reap all the potential benefits from this far brighter international environment. And so the euro-zone acceleration outpaced our own, giving the impression that France had trouble keeping up with the flow. Three factors dampened the impact of a buoyant international environment: first, our difficulty in preserving market share, in an admittedly exacerbated competitive climate; second, an ever greater penetration of imports; third, a milder business-investment rebound than in earlier cyclical upswings. The only component that held firm was household consumption. While it did not surpass the average increase in household income, it remained the true engine of the French economy.

These mixed economic results are reflected in the persistence of the soft-growth pattern that has characterized France since 2004, making the "classical" interpretation in cyclical terms somewhat inoperative.

The year of German and European recovery

The main economic development of 2006 is Germany's brisk recovery. German confidence surveys—particularly the IFO index—reported a euphoric business climate from January 2006 on.[1] With a 2.9% GDP expansion in 2006 (after 1.1% in 2005), the survey findings were steadily corroborated during the year. By comparison with our mid-2006 analysis, the international situation thus turned out to be, on balance, even better than expected for our economy *(see box 1)*.

The specific feature of this recovery is that it has been driven almost entirely by supply factors. Germany became the world's leading exporter again and investment jumped 6.4%, while manufacturing output gained an exceptional 6.1%. By contrast, demand components remained surprisingly inert: household consumption, for example, rose only 0.9% owing to the decline in real earnings.

The euro zone's average growth was close to Germany's—accelerating from 1.5% to 2.8%—but France gave the impression of not following the trend. Whether in confidence surveys *(Chart 1)* or in industrial performance, the French economy failed to match its partners' results,[2] despite its more robust domestic demand.

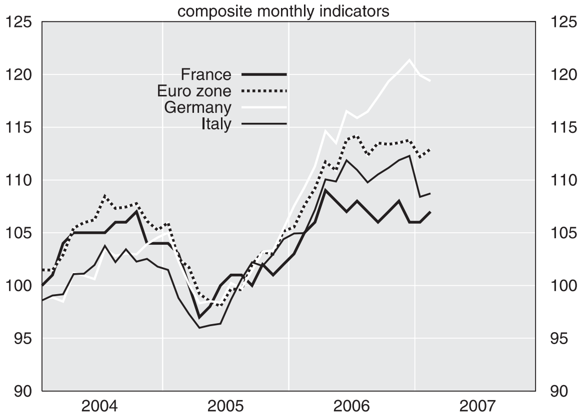
An oil shock… without inflation

After rising nearly $25 between 2003 and 2005, the average barrel price of Brent crude oil gained a further $10 in 2006. By mid-year, when it crossed the $75 threshold, the real oil price[3] had almost returned to its level after the second oil shock. In the end, however, France did not relive the trauma of the 1970s oil shocks.[4]

1

FRANCE OUTPACED BY THE EUROPEAN RECOVERY IN 2006?

composite monthly indicators



Sources: European Commission, INSEE computations

The shock's inflationary consequences were curtailed by the decrease in energy intensity relative to earlier oil shocks and by greater competition. The growing involvement of the main emerging countries—principally China and India—in world trade and the consequent decline in prices of manufactured imports continued to act as a highly potent inhibitor of inflation. In France, the Galland Act reform also led mass retailers to trim their margins. As a result, inflation eased from 1.8% in 2005 to 1.6% in 2006.

In the end, the only genuine sign of the 2006 oil shock was the widening of our external deficit. The shock's impact on French trade was all the greater as demand from oil-exporting countries proved weaker than in previous shocks.[5] The latest oil shock therefore helped to widen the current-account deficits of regions and countries already in the red, notably the United States. In the case of France, the bilateral trade balance with oil suppliers increased substantially, as the recycling of petrodollars via purchases of French products was rather modest as well.

Almost all over the world, disinflationary forces largely outweighed the direct impact of the oil shock. In Germany in particular, the decline in real wages continued to drive inflation down, from 2.0% in 2005 to 1.7% in 2006.

Monetary tightening was enacted nearly everywhere: the Fed raised the Fed Funds rate again, bringing the total increase to 425 basis points since 2004; the European Central Bank (ECB) lifted its key rate several times in 2006, for a total increase of 150 basis points since 2005. These moves had only a modest, late influence on the real economy, as the upturn in short-term interest rates was not fully transmitted to long-term rates.[6] This situation reflects the credibility acquired by central banks, the narrowing spreads in response to the reduced volatility of growth and prices, and the increase in reserves by Asian central banks and oil countries.

1. See "L'Allemagne se qualifie pour la reprise" [Germany qualifies for the recovery], in *Note de conjoncture*, June 2006, p. 29 [French ed. only].
2. See "Can we detect a cyclical gap in industry between the industries of the euro-zone's major countries since 2005?," "*Conjoncture* in France," March 2006, p. 36.
3. Price deflated by consumer price index.
4. The phenomenon was first analyzed in the article "A subdued oil shock," "*Conjoncture* in France," Dec. 2005, p. 11.
5. See "The recycling of the petrodollars," "*Conjoncture* in France," June 2006, p. 24.
6. See "Should we be afraid of long-term bond rates?," "*Conjoncture* in France," March 2006, p. 11.

Vibrant globalization… from which French exports benefited modestly

The "globalization" phenomenon gained breadth in 2006. After the episode of the elimination of "Chinese textile quotas" followed by their reinstatement in 2005,[7] the most striking illustration was the tremendous surge in trade between China and the rest of the world. Chinese export growth has been extraordinary (25% year-on-year in 2006 for merchandise exports in nominal terms) and is boosting China's trade surplus year after year. But the increase in exports to China is equally spectacular. At end-2006, China was (along with the Near East) the fastest-growing destinations of German and Italian exports.

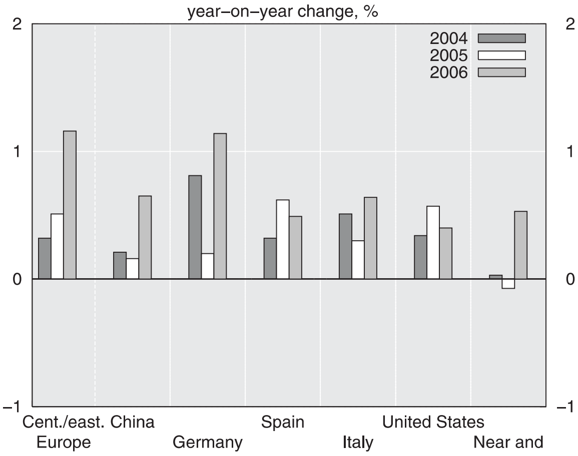
French trade bears the stamp of this vibrant globalization. First, 2006 witnessed another sharp rise in French manufactured imports. Although the import content of total final demand[8] has not accelerated recently relative to its historical trend—a counter-intuitive phenomenon—the steady rise in import penetration continues: in 2006, the main engines of this process were the acceleration of business demand for producer durables and intermediate goods and of household consumption of manufactured goods (4.2%). Further losses of price competitiveness in the domestic market have strengthened the trend.

Second, exports regained some vigor, growing 6.2% in 2006 versus 3.2% in 2005. French exports have almost stopped losing market share, in particular because of sharply accelerating demand from our closest neighbors, easier to satisfy than that of more distant countries *(Chart 2)*. As a result, external trade made another negative contribution to GDP growth, but of only 0.4 points compared with 0.9 points in 2005.

2

CONTRIBUTIONS TO FRENCH EXPORTS BY DESTINATION

year–on–year change, %



Source: French customs

Another lackluster year for industry

Despite the improvement in exports, French industry did not pull out of the doldrums in 2006. With only 1.4% growth, manufacturing output was disappointing, although a shade better than the 0.3% for 2005, and even though inventory-building behavior—as currently registered in the quarterly accounts[9] —seems to have weighed on production. Inventories eroded manufacturing-output growth by an estimated 0.4 points in 2006. If the figures are confirmed, this negative contribution of inventories means that the underlying robustness of industrial production was somewhat underestimated in 2006… a good omen for 2007.

The automotive industry significantly undercut total gains in manufacturing.[10] Its negative performance is not due to a structural weakening of domestic demand. The main cause is a loss of price and non-price competitiveness, which has stimulated import growth and slowed exports. French automakers have lost market share in France and Europe to their Japanese and South Korean rivals—who have captured one-sixth of the European market—and to German firms since 2004. The latter continue to benefit from labor-cost restraint, forcing French producers to trim their margin ratios to all-time lows in order to stay competitive. The workforce adjustment in the French automotive industry chiefly concerned temporary jobs.[11]

7. See "Impact de l'épisode de suppression et de rétablissement des quotas sur les textiles chinois" [Impact of the episode involving elimination and reinstatement of Chinese textile quotas], *Note de conjoncture*, June 2006, p. 46 [French ed. only].
8. See "Possible interpretation of the strength of manufacturing imports," "*Conjoncture* in France," March 2006, p. 9.
9. Pending the release of corporate accounts, the quarterly accounts contain no direct information on inventories. These are largely computed as the balancing item between supply, measured by the IPI, and demand, measured by various indicators. Changes in inventories for 2006 are therefore subject to the measurement errors generated for these items by using the above-mentioned indicators, which are available sooner than the data ultimately used to prepare the final annual accounts, but which, by definition, provide no more than an imperfect gauge.
10. See "Retour sur la conjoncture automobile française" [The French automotive-industry cycle revisited], *Note de conjoncture*, March 2006, p. 116 and "Vers une nouvelle donne sur le marché mondial de l'automobile?" [Toward a new situation in the global automobile market?], *Note de conjoncture*, December 2006, p. 99 [French eds. only].
11. See "Dans quels secteurs marchands l'emploi intérimaire est-il un moyen d'ajustement de l'emploi à la production?" [Which market sectors use temporary employment as a means of adjusting employment to production?], *Note de conjoncture*, June 2006, p. 92 [French ed. only].

The vigor of French consumption now depends on income alone

Amid this weakness of industry, France's growth rebound was mainly driven by the robust behavior of consumption, which gained 2.7% in 2006 versus 2.2% in 2005. The surprising development in household demand was the end of the decline in the saving rate. Unlike the pattern in Anglophone countries, the use of short-term debt to finance consumption has never really caught on in France.[12]

The saving rate thus remained virtually stable at 14.9% in 2006 versus 15.0% in 2005. Consumption growth was fueled almost entirely by real gross disposable income (GDI), up 2.7% in 2006 versus 1.3% in 2005. The latter aggregate was boosted by the recovery in unincorporated-enterprise earnings, higher real wages, increased distribution of bonuses (particularly by financial companies), and an improved labor market.

With the customary lag, the upturn in employment effectively followed the economic turnaround in mid-2005. But the recovery in market-sector employment is not yet very vigorous, for two reasons: first, overall economic growth remains slack; second, the phase of job-rich growth characteristic of the 1990s is now behind us.

A very flat cycle

Viewed in a medium-term context, the current period seems unusual for the slackness of the economic recovery—not only in GDP growth but also in employment and investment. Since 2004, the French economy has been experiencing sluggish growth, never below 1%, but never above 2.5%. The present cycle is thus very flat in comparison with previous cycles, a finding corroborated by business and consumer surveys.

This distinctiveness is far less visible in Germany. German growth dipped well below the French rate between 2001 and 2005, with an average 1% gap in France's favor. In 2006, the growth differential reversed, with Germany posting 2.9% to France's 2.0%.[13] However, the growth drivers are not identical in both countries.[14] The German expansion is largely fueled by manufacturing, while construction has ceased making a negative contribution since mid-2005.

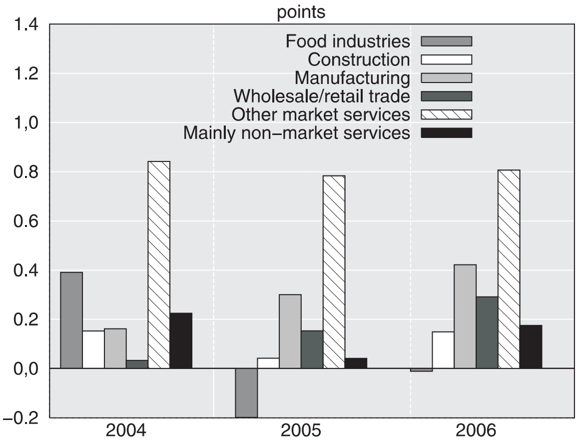
In France, market services have been the main engine since 2003, although the growth mix is now shifting thanks to an acceleration trend in other sectors. Between 2005 and 2006, the fresh momentum has been provided chiefly by the food industries, wholesale/retail trade, and manufacturing *(Chart 3)*.

In this flat cycle, business investment has been particularly limp, growing by less than 4% in both 2005 and 2006 *(Chart 4)*.

This finding should, however, be qualified in two ways. First, the investment ratio, now over 18%, is relatively high and close to its peaks of the 1980s-1990s. Second, France does not differ in this respect from its European partners except

3

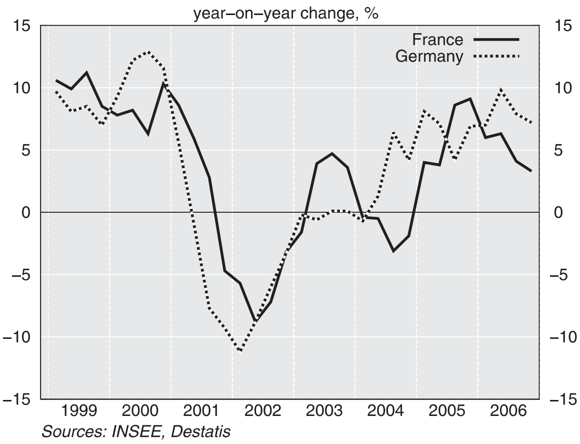
AN ATYPICAL RECOVERY?
SECTOR CONTRIBUTIONS TO GROWTH IN VALUE ADDED



Source: INSEE

4

INVESTMENT IN FRANCE AND GERMANY: LAGGED RECOVERY



Sources: INSEE, Destatis

12. See "L'impact des crédits de trésorerie sur l'évolution de la consommation des ménages en France et au Royaume-Uni" [Impact of cash advances on changes in French and U.K. household consumption], *Note de conjoncture,* June 2006, p. 104 [French ed. only].
13. Annual average GDP growth adjusted for working days, i.e., the figure published in the quarterly national accounts. The raw-growth gap published in the annual accounts is of the same order of magnitude.
14. See "Comparison of current recoveries in France and Germany: which sectors are leading the way?," "*Conjoncture* in France", Dec. 2006, p. 37.

Germany, where business investment has picked up at a livelier pace but where the investment ratio remains well below its previous cyclical peak. Germany was hit far harder by the bursting of the Internet bubble, whose effects on investment lingered on because of the crisis and the restructuring operations that it entailed in the financial sector. By contrast, France's distinguishing feature appears to be a greater resilience of investment in the slowdown of the early 2000s—which, conversely, explains the weaker performance that followed and the relatively high investment ratio. This diagnosis is confirmed by a more detailed analysis of the changes in business investment by comparison with those of its standard determinants.[15] One significant conclusion is that, if investment diverged from the path forecast by its determinants, it was only in the first two years of the current cyclical upswing, and in a rather more positive sense than expected.

The French economy therefore ended 2006 with mixed results. Household demand provides it with a core growth engine that does not seem in jeopardy; global conditions are also rather favorable. Yet France has had trouble latching on to the current European recovery. The manufacturing sector and external trade—the French economy's two weak spots in 2006—have prevented the present cycle from developing a clearcut profile.

15. See article "Equipment investment in France and the euro zone euro: similarities and differences with respect to the previous cycle," "*Conjoncture* in France," Dec. 2006, p. 9.

Box 1: Post-mortem on French economic forecast in June 2006 "*Conjoncture* in France"

In June 2006, INSEE[16] forecast 2.0% growth for the full year 2006. In the end, the French economy did grow 2.0%. However, the activity profiles *(Chart A)* and the macroeconomic sequence of events proved to be substantially different from the forecast scenario.

In order to understand the differences between forecasts and outcomes, we perform a retrospective analysis of the forecasts in the June 2006 "*Conjoncture* in France" for the year 2006 using the Mésange macroeconomic model.[17]

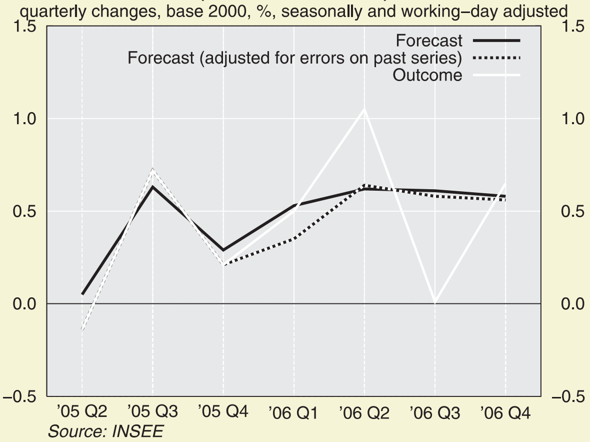
The Table presents the growth determinants and compares their impact between the June 2006 and March 2007 scenarios. We find that, all other things being equal, France's international environment as actually observed would, if correctly predicted, have led to a 1.3-point increase in the growth forecast. However, this under-estimation of the vigor of foreign demand was offset by an equivalent overstatement of economic agents' behavior. If we had taken into account the behavior actually observed, we would have lowered our growth forecast by 1.1 points.

The actual international environment in 2006 explains the Q3 2006 dip in economic activity, but does not explain the zero growth rate for that quarter *(Chart B)*. The gap between the growth forecast assuming knowledge of the 2006 environment and its outcome is therefore due to deviations in economic agents' behavior from the June 2006 "Conjoncture in France" forecast and the modeling of their behavior in Mésange. More specifically, we find a gap between forecast and actual imports and exports in real terms. ■

16. *Note de conjoncture* [English ed.: "*Conjoncture* in France"], June 2006.
17. This review of 2006 is performed with the aid of the Mésange model re-estimated on base-2000 long-term series. The re-estimation was conducted jointly by INSEE and the Finance Ministry's Directorate-General of the Treasury and Economic Policy (DGTPE). The specifications chosen are currently being described in detailed explanatory notes. However, this version of the base-2000 model is not fully stabilized. First, studies currently under way on the model's variant behaviors may lead to some changes in the price equations. Second, re-estimations will be performed after the publication of the May 2007 quarterly accounts. The latter will take into account the results of the second back-casting of the annual accounts and will be formulated in chained-prices terms.

A

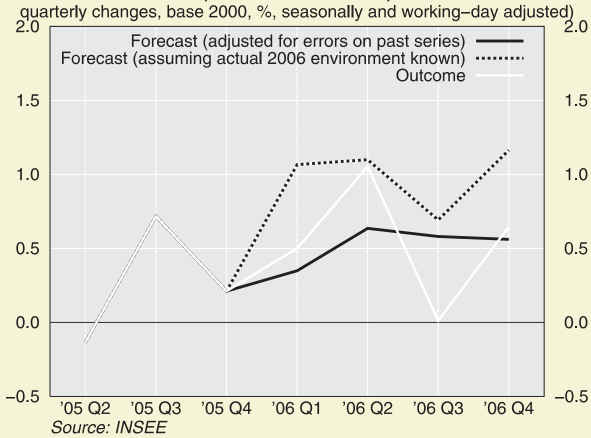
REAL GDP GROWTH
(forecast and outcome)
quarterly changes, base 2000, %, seasonally and working–day adjusted



Source: INSEE

B

REAL GDP GROWTH
(forecast and outcome)
quarterly changes, base 2000, %, seasonally and working–day adjusted)



Source: INSEE

How to read these charts:
The gaps between forecast and actual figures can be explained as follows. First, the 2005 national accounts used in the June 2006 forecast are, of course, not yet finalized. The forecast is therefore based on non-final series of quarterly national accounts. Second, there is a difference between the forecast and the actual environment variables. Third, our assumptions concerning economic agents' behavior in the June 2006 "Conjoncture in

Table
Breakdown of comparison between growth forecast and outcome

Real GDP growth (i.e., inflation-adjusted) (%)	**2005**	**2006**
June 2006 "Conjoncture in France"	1.2	2.0
Revision of national accounts (March 2007)		-0.2
International environment in 2006		+1.3
Of which: Competitiveness		*+0.5*
Oil		*0.0*
Global demand		*+0.3*
Exchange rate		*+0.1*
Other		*+0.4*
Behavior		-1.1
Of which: Household consumption		*-0.1*
Change in inventories		*-0.2*
Investment		*0.0*
Imports		*+0.4*
Exports		*-1.0*
Intermediate-consumption prices		*-0.1*
Other		*-0.1*
Outcome	1.2	2.0

How to read this table:
The June 2006 "Conjoncture in France" forecast 2.0% growth for France in 2006. The account revisions performed until February 2007—which only concerned the quarters prior to Q2 2006—trimmed annual growth by 0.2 points. The gaps between the forecast and actual international environment for 2006 should have entailed—all other things being equal—a 1.3-point increase in the growth forecast on the June 2006 scenario. On the other hand, factoring in actual economic agents' behavior would have reduced the growth forecast by 1.1 points. Summing the contributions of these differentials gives us the actual growth figure of 2.0%.
Source: INSEE

Box 2: Post-mortem on euro zone economic forecast in June 2006 "*Conjoncture* in France"

In June 2006, "*Conjoncture* in France" forecast 2.0% GDP growth for the euro zone in full-year 2006. The actual annual average is estimated at 2.8%, well above the mid-year forecast.

This box reports our retrospective analysis of the 2006 forecasts published in the June 2006 "*Conjoncture* in France," using the MZE euro-zone model.[18]

Our economic scenario for the euro zone in June did not expect growth to accelerate in Q2 and foresaw a mild slowdown to an average 0.5% per quarter in Q3 and Q4. The scenario was invalidated on two counts. First, H1 growth, including revisions, proved twice as fast as we expected in June. Second, while the economy did lose momentum in H2, the expansion continued at a pace exceeding our forecast, i.e., by an average 0.7% per quarter *(Chart A)*.

The main weakness of our scenario concerns external trade, which explains most of the forecasting error for annual average GDP growth in 2006. Several factors escaped our short-term analysis, most notably the variations in exchange rates, oil prices, and global demand for euro-zone products. However, the errors on these exogenous variables should have led us to overstate rather than understate GDP growth, particularly in Q2 and Q4. In Q2, imports proved to be far weaker than what the demand and competitiveness profiles suggested. In Q3 and especially Q4, exports performed far better than what recent trends led us to expect *(Chart B)*.

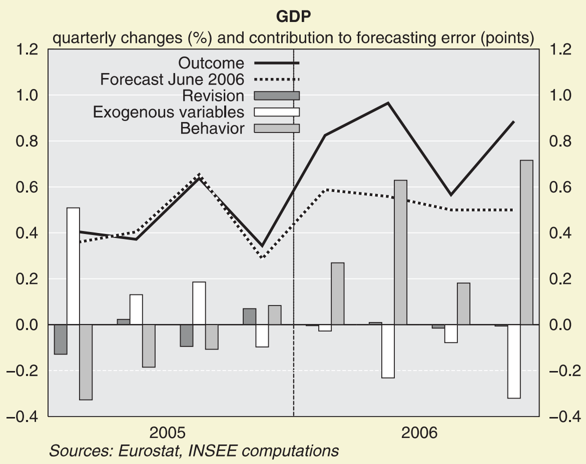
As regards exports, the U.S. economic slowdown in H2 2006 was correctly forecast, as well as its consequences on demand for euro-zone products. Yet the zone's exports rose by a robust 3.7% in Q4, largely thanks to shipments to China, Switzerland, OPEC, and Russia.

The behavior gap is harder to explain for imports. The MZE import equation is, by convention, specified as an error-correction model with a long-term equilibrium between imports, domestic demand, and exports. Domestic demand was strongly driven by construction investment; in 2006, this sector pulled out of crisis in Germany and posted strong growth. However, the MZE model does not distinguish between construction investment and equipment investment, whereas the two aggregates have very different import contents. In addition, the model is estimated only from 1995 onward, i.e., after the onset of the German construction slump. As result, the investment elasticity of imports is probably overvalued, which may explain part of the gap between the import behavior predicted by the MZE model and the behavior actually observed in 2006.

The main component of domestic demand, household consumption, does not exhibit a gap between the June forecast and its outcome, at least as regards its annual average gain of 1.8% *(Chart C)*. Nevertheless, the MZE model diagnostics reveal a combination of two errors with opposite effects. On the one hand, we overestimated

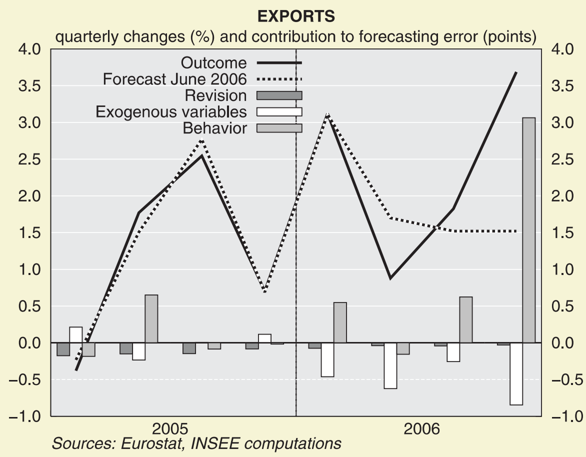
18. The MZE model (Modèle Euro Zone, i.e. Euro-Zone Model) was developed in cooperation by INSEE and the Finance Ministry's Directorate-General of the Treasury and Economic Policy (DGTPE). It is based on Eurostat data and comprises about twenty error-correction econometric equations, now estimated between 1995 and 2005.

A



Sources: Eurostat, INSEE computations

B



Sources: Eurostat, INSEE computations

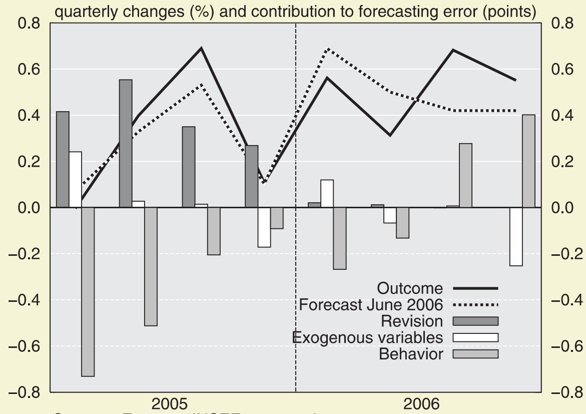
How to read these charts:
The MZE model describes changes in the euro-zone economy as a function of two types of variables: (1) the model's "exogenous" variables (mainly the euro-zone's international-environment variables—such as foreign demand, the euro's effective exchange rate, and the oil price—and public-finance variables), which the model takes for granted and does not seek to explain; (2) the "residuals" of "behavior equations" that reflect the differentials between major economic variables (such as consumption, investment, exports, and consumer prices) and their average behavior, as estimated by econometric techniques. By simulating the impact of each exogenous variable and each residual as measured today and as forecast in June 2006, we can then estimate each item's contribution to the forecasting error. For example, in Q2, the gap between actual growth (almost 1%) and growth forecast in the June 2006 "Conjoncture in France" (under 0.6%) is attributable to a more-favorable-than-expected change in behaviors (contributing 0.6 points), partly offset by a less-favorable-than-expected change in the exogenous variables, which reduced growth by 0.2 points.

households' disposable income in 2005, on the basis of data published in June but later revised. Consequently, if we had known the actual change in the standard determinants of household consumption in June, we would have lowered the full-year growth forecast for the aggregate by 0.4 points. On the other hand, in annual terms, household consumption proved to be less vigorous than its standard determinants (income and unemployment rate) would have led us to expect: this has been a consistent pattern since 2004. n

C

PRIVATE CONSOMPTION

quarterly changes (%) and contribution to forecasting error (points)



Sources: Eurostat, INSEE computations